New IRS Correction Rules for Retirement Plans

Common 401(k) and 403(b) Errors and Correction Methods

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General Principles

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General Principles

Common Errors:

- Exclusion of eligible employees.
- Miscalculation of contributions (employee deferrals, after-tax contributions, matching contributions, or employer nonelective contributions).

Less common errors not discussed in this outline, but as to which corrections must also be made, include:

- Failure to update the plan document for the Required Amendments List.
- Maintenance of a plan by an ineligible employer (typically, governmental employer adopting a 401(k) plan or tax-exempt other than a 501(c)(3) adopting a 403(b) plan).
- ADP and ACP failures were not timely corrected.
- Deferrals exceeded the 402(g) limits.
- Participant loan errors.
- Hardship distribution errors.

Although this outline refers mostly to 401(k) plans, the same rules apply to 403(b) plans.

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General Principles

Time Deadlines:

- All time deadlines for correct contributions to begin in order to take advantage of lowered qualified nonelective contribution (QNEC) obligation assume that the affected employee did not call the employer's attention to the error. If the Plan Sponsor was notified of the failure by the affected eligible employee, correct contributions must be made by the earlier of
  - The time deadline that would otherwise apply or
  - The first payment of compensation made on or after the end of the month after the month of notification.
- Distinction between SCP deadline and deadline for correct contributions to begin in order to take advantage of lowered QNEC obligation:
  - For SCP, a significant error must be "substantially corrected" on or before the last day of the third plan year following the plan year in which the failure occurred. This allows some margin where correction is far along, but some details still need to be worked out.
  - To be eligible for lowered contributions, correct deferrals must begin by the deadline. There is no margin for less than complete compliance. However, earnings need not be contributed by the deadline.

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General Principles

Notice to Employees:

- Certain relief provisions depend on providing notice to employees. Notice must provide:
  - General information relating to 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. The general information need not include a statement of the dollar amounts that should have been deferred.
  - A statement that appropriate amounts have begun to be deducted from compensation and contributed to the plan (or that appropriate deductions and contributions will begin shortly).
  - A statement that corrective allocations have been made (or that corrective allocations will be made). Information relating to the date and the amount of corrective allocations need not be provided.
  - An explanation that the affected participant may increase his or her deferral percentage in order to make up for the missed deferral opportunity, subject to applicable limits under § 402(g).
  - The name of the plan and plan contact information (including name, street address, email address, and telephone number of a plan contact).
- Presumably, not all of these would be relevant to a terminated employee, but Rev. Proc. 2021-30 does not discuss any alterations that might be appropriate in this situation.

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Erroneous Exclusion of Employees

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Erroneous Exclusion of Employees

How does it happen? Most common scenarios are:

- New employees in plans with automatic contributions:
  - Plan provides for an eligible automatic enrollment arrangement (EACA) or qualified automatic enrollment arrangement (QACA)
  - The plan says new employees are enrolled effective on the date of hire.
  - EACA or QACA notice must be given on the date of hire, or at latest before the pay date for the pay period in which the employee becomes eligible.
  - Time required for TPA to learn of the new hire and give the notice may be longer than the allowed time.
- Casual employees
  - Employer may not think of certain employees (e.g., interns) as being eligible for the plan.
  - Employer may not have adequate systems in place to include part-time or temporary employees once they hit 1,000 hours.
- Failure to provide timely safe-harbor notice required by Code Sec. 401(k)(12)

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Erroneous Exclusion of Employees

Erroneous exclusion of employees potentially results in four errors:

- Exclusion from making pre-tax contributions (automatic or elective), referred to in Rev. Proc. 2021-30 as "deferrals."
- Exclusion from making after-tax contributions.
- Exclusion from matches.
- Exclusion from nonelective employer contributions.
- Employee did not receive earnings on contributions that should have been made.

Each of these errors must be corrected separately. **Common employer error:** Overlooking the need to correct the employee's exclusion from after-tax contributions.

Exclusion from making Roth contributions need not be corrected in a situation involving erroneous exclusion of employees. It is assumed that employees would have made pre-tax rather than Roth contributions.

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Erroneous Exclusion of Employees: Correction of Pre-Tax Contributions

Make-up for employee exclusion from making pre-tax contributions not required if:

- Failure corrected by the first paycheck that is more than three months after the error occurred, if notice is given to the employee not later than 45 days after the date on which correct deferrals begin.
- Employees subject to an automatic contribution feature, if failure does not extend beyond the end of the 9½-month period after the end of the plan year of the failure. (Rev. Proc. 2021-30 extended this relief from failures that begin on or before December 31, 2020 to those that begin on or before December 31, 2023.)
- Employee has the opportunity to make contributions for the last nine months of the plan year, and is permitted to make the full contributions for the year during that nine month period.

This relief applies only to making up pre-tax contributions that the employee was erroneously excluded from making. **Common employer error:** Overlooking the need to correct after-tax contributions, matching contributions, or nonelective employer contributions if make-up of pre-tax contributions is not required.

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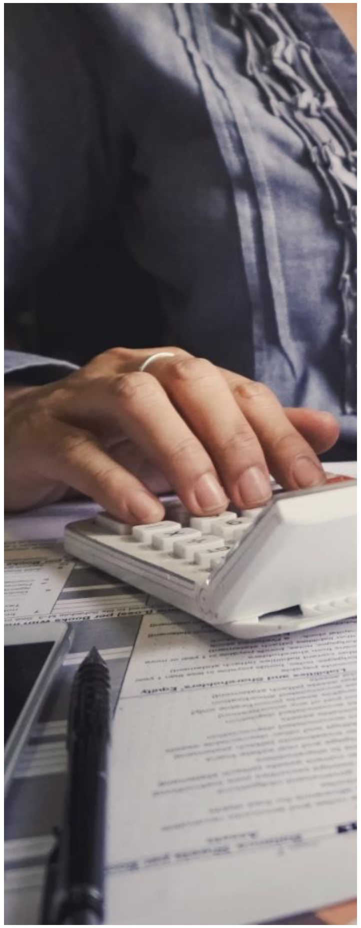
Erroneous Exclusion of Employees: Correction of Pre-Tax Contributions



If make-up for employee exclusion from making pre-tax contributions is required:

- Determine the amount of the "missed deferral."
- Employer must make a QNEC equal to the "missed deferral opportunity," which is a portion of the missed deferral.

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Erroneous Exclusion of Employees: Correction of Pre-Tax Contributions

What is the missed deferral?

The missed deferrals are the following, subject to the 402(g) dollar limit on deferrals:

- Safe harbor plan with a safe harbor match – the greater of:
  - 3% of compensation; or
  - The maximum deferral percentage for which the employer provides a matching contribution rate that is at least as favorable as 100% of the elective deferral made by the employee.
- Safe harbor plan with a safe harbor nonelective contribution:
  - 3% of compensation.
- All other plans:
  - The average deferral percentage of the group (highly compensated employees or nonhighly compensated employees) to which the employee belongs

Common employer error: Believing that the missed deferral is equal to the automatic contribution (which may include automatic escalation) that should have been made. Such a correction would apply if the employee got notice of their inclusion in the plan but the employer failed to implement the automatic enrollment provision but does not apply if the employee was erroneously excluded.

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Erroneous Exclusion of Employees: Correction of Pre-Tax Contributions

What QNEC must the employer make to correct the missed deferral?

- The contribution is equal to the “missed deferral opportunity.”
- If correct deferrals begin later than the first paycheck that is more than three months after the error occurred, but no later than the first payment of compensation made on or after the last day of the third plan year following the plan year in which the failure occurred, and notice is given to the employee within 45 days after the date when correct deferrals began, “missed deferral opportunity” is 25% of the missed deferral. (Rev. Proc. 2021-30 changed this from the second plan year to the third plan year.)
- If the preceding paragraph does not apply, “missed deferral opportunity” is 50% of the missed deferral.

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Erroneous Exclusion of Employees: Correction of After-Tax Contributions

- Make-up for employee exclusion from making after-tax contributions is always required if the plan permits after-tax contributions. The various relief provisions applicable to exclusion from pre-tax contributions do not apply to after-tax contributions.
- The employer must contribute a QNEC equal to the "missed opportunity for making after-tax employee contributions."
- The missed opportunity for making after-tax employee contributions is equal to 40 percent of the employee's "missed after-tax contributions."
- Two alternatives for determining missed after-tax contributions:
  - The ACP for the employee's group (either highly compensated or nonhighly compensated) times the employee's compensation, but with the resulting amount not to exceed applicable plan limits, or
  - The portion of the ACP that is attributable to after-tax employee contributions for the employee's group (either highly compensated or nonhighly compensated), multiplied by the employee's compensation for the year of exclusion.

Many employers find it counterintuitive that QNECs for after-tax contributions would be required for a brief failure for which no QNEC or a reduced QNEC would be required for pre-tax contributions, given that far more employees typically make pre-tax contributions than after-tax contributions.

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Erroneous Exclusion of Employees: Correction of Matching Contributions

- Make-up for matching contributions is *always* required if the plan provides for a match. The various relief provisions applicable to exclusion from pre-tax contributions do not apply to matching contributions.
- The employer must make a matching contribution equal to the matching contributions that should have been made on the "missed deferrals" plus, if the plan provides for matching after-tax contributions, the "missed after-tax employee contributions."
- In a plan that provides for safe harbor matching contributions, the match for after-tax contributions will always be less than 100%. This is because the missed pre-tax deferrals will be the highest percentage of compensation that would have been subject to a 100% match, so any after-tax contributions will be subject to a lower match or no match, depending on the plan terms.
- The missed matching contribution is based on the entire missed deferrals or missed after-tax contributions, not the missed deferral opportunity or the missed opportunity to make after-tax employee contributions. For example, if the plan provides for a safe harbor matching contribution of 100% of the employee's deferrals up to 5% of compensation, and none of the special relief provisions applied, the QNEC would be 50% of the first 5% of compensation, or 2.5% of compensation. However, the matching contribution would be 5% of compensation.
- Unlike QNECs, missed matching contributions are subject to the plan's vesting provisions for matching contributions. This can cause complicated calculations if forfeited account balances are normally reallocated among the remaining employees.

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Erroneous Exclusion of Employees: Correction of Nonelective Employer Contributions

The correction of nonelective employer contributions varies depending on how nonelective contributions are structured:

- Contributions which, either according to the terms of the plan (e.g., safe harbor nonelective contributions) or according to a resolution providing for discretionary contributions, are a fixed percentage of compensation.
- Discretionary contributions which are in a total amount specified by a resolution providing for discretionary contributions.

Erroneous Exclusion of Employees: Correction of Nonelective Employer Contributions

Correction of the contributions which are a fixed percentage of compensation is relatively straightforward. The employee should receive a contribution in the same percentage of compensation as they would have received if they had been included in the plan as soon as they became eligible. Any amounts which would have been forfeited should be reallocated in accordance with the plan's provisions concerning forfeitures.

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Erroneous Exclusion of Employees: Correction of Nonelective Employer Contributions

Correction of contributions which are in a total amount specified by a resolution is much more complicated.

- If the contributions had been allocated as they should have been, the excluded employees would have received a portion of them – but all the other employees would have received a smaller portion than they otherwise did.
- Under the normal EPCRS goal of putting employees into the position they would have been in absent the error, the plan would need to recoup money from all the employees other than the excluded employees. This can be particularly difficult in the case of employees who have left and taken a complete distribution, although Rev. Proc. 2021-30 ameliorates the administrative burden by increasing from $100 to $250 the de minimis amount the employer does not have to attempt to recoup.
- To the extent that money is merely transferred from the accounts of employees who received too much to the accounts of employees who received too little, there may be little or no employer cost to correcting employer nonelective contributions. However, to the extent the employer is unable to recoup amounts from employees, it must make a contribution to make up the deficit.
- It is our understanding that in at least some instances, the IRS has approved corrections which involved simply topping up the contribution, rather than recouping money from all employees other than the excluded employees.

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Erroneous Exclusion of Employees: Earnings Calculations

- QNECs for pre-tax and after-tax contributions, corrected matching contributions, and corrected employer nonelective contributions must all be credited with earnings from the date they should have been transmitted to the plan to the date they are actually transmitted to the plan.
- Provided that the plan is complying with Department of Labor guidance concerning when contributions should be transmitted to the plan or is not subject to such guidance (governmental or church plan), the plan's normal procedures would be examined to determine when the contributions should have been transmitted. If the plan is not in compliance with such procedures, that is a separate error that cannot be corrected under EPCRS but requires a separate correction with the Department of Labor.
- The earnings rate to be used for the excluded employees is normally the average earnings rate of the plan as a whole. However, for simplicity, the employer can use the investment with the highest earnings rate.

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Incorrect Calculation of Contributions

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Incorrect Calculation of Contributions

How does it happen? Most common scenarios are:

- Employer gives the employee the required safe harbor notice but fails to implement an automatic contribution arrangement when employee makes no deferral election.
- Employer obtains an election from the employee regarding deferrals, Roth contributions, or after-tax contributions, but then fails to implement it due to a clerical error.
- Employer miscalculates compensation when employee elects to defer a specified percentage of compensation or to make after-tax contributions equal to a specified percentage of compensation.
- Employer cuts off contributions at the normal 402(g) limit, even though the plan permits catch-up contributions.

In some instances, matching or employer nonelective contributions may be higher than the plan provides.

For example, a safe harbor plan may provide for matching contributions equal to 100% of the first 3% of compensation, and 50% of the next 2% of compensation. If the employer instead matches 100% of the first 3% plus 50% of the next 4%, this can typically be dealt with via a retroactive amendment to the plan rather than any kind of correction of the contributions.

Incorrect Calculation of Contributions

Erroneous calculation of contributions potentially results in five errors:

- Miscalculation of deferrals.
- Miscalculation of Roth contributions.
- Miscalculation of after-tax contributions.
- Miscalculation of matches.
- Miscalculation of nonelective employer contributions.
- Employee did not receive earnings on contributions that should have been made.

Common employer error: Assuming that there was no error in pre-tax, Roth, or after-tax contributions because the employee could see what contributions were being made and could have increased contributions if they were dissatisfied with the amount. For example, suppose the employee elected to defer 5% of compensation, and the employer believed the employee's compensation was $50,000. Thus, $2,500 was deferred. It is later determined that the employee's compensation was $60,000, so the deferral should have been $3,000. This error requires correction, even though the employee could have achieved a $3,000 contribution by electing to contribute 6% rather than 5% of compensation.

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Incorrect Calculation of Contributions

In the case of correction of incorrect contributions, unlike in the case of correcting the exclusion of employees:

- Because either the employee has made a deferral election, or the employee is subject to the automatic contribution provisions, we know what deferrals (regular and/or Roth) would have been made in the absence of the error.
- We know what investment elections the employee would have made (or in the case of an error in applying the automatic contribution provisions, we know what the plan's default investment is).
- We know whether the employee has taken a distribution and if so, when the distribution took place.

Incorrect Calculation of Contributions: Correction of Pre-Tax Contributions

As with erroneous exclusion from a plan, no QNEC is required if:

- Failure is corrected by the first paycheck that is more than three months after the error occurred, if notice is given to the employee not later than 45 days after the date on which correct deferrals begin.
- Employees subject to an automatic contribution feature, if failure does not extend beyond the end of the 9½-month period after the end of the plan year of the failure. (Rev. Proc. 2021-30 extended this relief from failures that begin on or before December 31, 2020 to those that begin on or before December 31, 2023.)
- The employee is permitted to make contributions for at least the last nine months of the year and is entitled to make the full contribution for the year during that nine-month period.

If make-up for incorrect calculation of pre-tax contributions is required:

- Determine the amount of the “missed deferral.”
- Employer must make a QNEC equal to the “missed deferral opportunity,” which is a portion of the missed deferral.

Incorrect Calculation of Contributions: Correction of Pre-Tax Contributions

What is the missed deferral?

Regardless of whether the plan is a safe harbor plan, the missed deferral is the lesser of:

- The excess of the deferral that should have been made over the deferral that was actually made, or
- The 402(g) limit (including catch-ups, if allowed by the plan and applicable to the participant).

Take our prior example of the employee who elected to defer 5% of compensation, when the employer erroneously believed the employee's compensation was $50,000 but it was actually $60,000.

- The deferral that should have been made was $3,000.
- The deferral that was actually made was $2,500.
- Thus, the missed deferral was $500.

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Incorrect Calculation of Contributions: Correction of Pre-Tax Contributions

What is the missed deferral in special situations?

- If the employee made no deferral election in a plan with automatic contributions, and the employer failed to implement the automatic contribution, the missed deferral is equal to the entire deferral that would have been made if the automatic contribution had been implemented.
- If the only error was failure to implement catch-ups in a plan which allowed for them, the missed deferral is 50% of the amount of the catch-up.
- If the incorrect calculation of the deferral extended to only a portion of the plan year, the missed deferral is calculated by multiplying the employee’s elected deferral percentage by the employee's plan compensation for the portion of the year during which the employee was improperly excluded. (The rules for partial years are new in Rev. Proc. 2021-30.)

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Incorrect Calculation of Contributions: Correction of Pre-Tax Contributions

What is the missed deferral opportunity?

- If correct deferrals begin later than the first paycheck that is more than three months after the error occurred, but no later than the first payment of compensation made on or after the last day of the third plan year following the plan year in which the failure occurred, and notice is given to the employee within 45 days after the date when correct deferrals began, "missed deferral opportunity" is 25% of the missed deferral. (Rev. Proc. 2021-30 changed this from the second plan year to the third plan year.)
- If the preceding paragraph does not apply, the "missed deferral opportunity" is 50% of the missed deferral.

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Incorrect Calculation of Contributions: Correction of Roth Contributions

The method for correcting an incorrect calculation of Roth contributions is identical to the method for correcting an incorrect calculation of pre-tax contributions. Thus, the QNEC is at a 50% rate unless one of the relief provisions applies, not at the 40% rate that would apply to after-tax contributions.

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Incorrect Calculation of Contributions: Correction of After-Tax Contributions Other Than Roth Contributions

As in the case of excluded employees, the method for correcting an incorrect calculation of after-tax contributions is for the employer to provide a QNEC equal to 40% of the missed after-tax contribution. However, rather than being based on the ACP (as would be the case if the employee had been excluded from electing after-tax contributions), the missed after-tax contribution is the excess of:

- The after-tax contribution the employee elected to make, over
- The after-tax contribution actually made.

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Incorrect Calculation of Contributions: Correction of Matching Contributions

As in the case of excluded employees, the employer is required to provide the matching contributions that would have been made if the missed deferrals had been made. However, there is a further wrinkle that in some instances, a matching contribution may be required even if the pre-tax contribution that was the basis for the matching contribution is correct.

Example: The plan provides that the match is 100% of the first 3% of compensation, and 50% of the next 2% of compensation. Juan (who has not attained age 50) elects to make a contribution of 15% of compensation. The employer believes his compensation is $200,000, but it is actually $250,000.

No QNEC is required because Juan's contribution was already cut off at the $19,500 402(g) maximum. However, the employer previously matched only the first $6,000 of Juan's contribution at the 100% rate, and matched the next $4,000 at the 50% rate, for a total match of $8,000. It should have matched the first $7,500 of Juan's contribution at the 100% rate and matched the next $5,000 of his contribution at the 50% rate, for a total match of $10,000.

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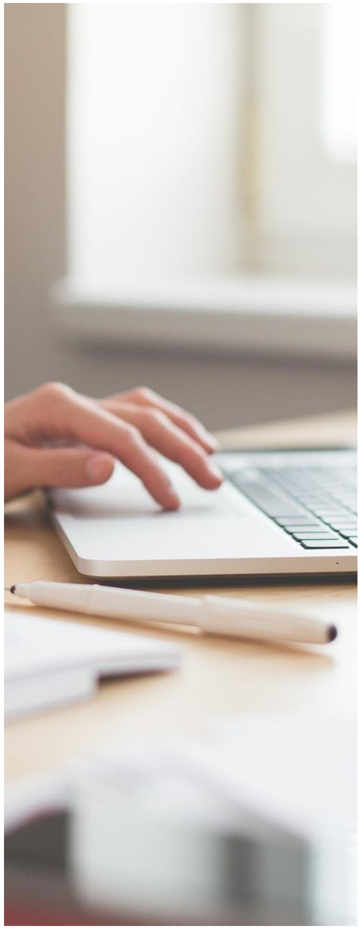
Incorrect Calculation of Contributions: Correction of Nonelective Employer Contributions



The correction in the case of incorrect calculation of nonelective employer contributions is a contribution equal to the excess of:

- The nonelective employer contribution that should have been made, over
- The nonelective employer contribution that was made.

However, as in the case of excluded employees, complications may arise if the employer elects to declare the total amount of a discretionary contribution, rather than declaring it as a percentage of compensation.

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Incorrect Calculation of Contributions: Correction of Earnings

- For any period before the employee took a complete distribution from the plan, earnings are calculated based on the employee's investment choices (or if the employee did not make investment choices, the plan's default investment).
- Rev. Proc. 2021-30 does not provide guidance on calculating earnings for any period after the employee took a complete distribution. It is our understanding that the IRS has on occasion allowed the use of the interest rate that the Department of Labor applies in the Voluntary Fiduciary Correction Program (VFCP) for the period from the complete distribution to the date correction is made.