Taking Corrective Measures

Steps plan sponsors can take to keep their defined contribution plans in compliance with the IRS.

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In the January/February 2008 issue of Defined Contribution Insights, *PSCA published an article from the Internal Revenue Service about common plan mistakes and how they can be corrected. In this piece, PSCA members Carolyn Trenda and Richard Menson of McGuireWoods LLP give further detail and explanation of the "top eleven" list.*

To assist plan sponsors with plan compliance, the Internal Revenue Service (IRS) recently released helpful guidance detailing common 401(k) plan mistakes and how they can be corrected. See their Web site at http://www.irs.gov/pub/irs-tege/401k_mistakes.pdf.

In this guidance, the IRS provides a summary of the "top eleven" errors as well as more detailed information regarding how to identify each issue, correction methods to use and examples of certain corrections. The IRS also re-summarizes the components of its Employee Compliance Resolution System (EPCRS), which includes a Self-Correction Program, a Voluntary Correction Program and an Audit Closing Agreement Program.

While correction through EPCRS is appropriate for some plan errors, other errors should be remedied through the Department of Labor's (DOL) Voluntary Fiduciary Correction Program (VFCP) or its Delinquent Filer Voluntary Correction (DFVC) program.

The IRS's "Top Eleven" are as follows:

1 Failing to Update the Plan

Plan text and operation should be reviewed at least annually and should constantly evolve to keep the plan within the law and to take advantage of any changes. The IRS' determination letter filing system demands that plan sponsors pay particular attention to updating plans during the applicable determination letter filing cycle, as plans that are not current will encounter difficulties in procuring a letter and retaining qualified status.

To aid plan sponsors in the effort to keep plans as updated as possible, the IRS publishes an annual list of changes called the "Cumulative List of Changes in Plan Qualification Requirements." This list also proves useful for determining which interim amendments should be made to keep the plan current in non-filing years. Where amendments have not been timely made, plan sponsors should adopt amendments for missed changes as soon as possible, and in certain instances sample amendments from the IRS may be available. A filing under EPCRS may be needed in connection with an amendment that is not timely adopted.

2 Inconsistencies: Operation vs. Documentation

The plan sponsor is ultimately responsible for keeping the plan in compliance; however, several people may work with a plan document: employees, vendors and other outside professionals. When changes are made, plan service providers should be timely notified to ensure that plan administration remains consistent with plan documentation.

To guard against operational errors, annual plan audits provide a useful opportunity for service providers to compare administration to documentation to make sure that the provisions of the plan are administered in accordance with the plan. When inconsistencies are revealed, plan sponsors should use a reasonable correction method that places affected participants in the position they would have been had there been no operational plan defect.

3 Inaccurate Definition of "Compensation"

Accurately applying a plan's stated definition of compensation is a key element to operating an error-free plan. A plan may contain different definitions of compensation for different plan purposes. Amounts may be considered "compensation" and be eligible for deferrals, but those same amounts may be excluded when calculating compensation for determining employer non-elective contributions or for nondiscrimination testing.

Additionally, many items may or may not be included in compensation; for example, the inclusion of expense reimbursements, car allowances, bonuses, commissions and overtime pay in compensation can vary from plan to plan. When an incorrect definition is used, the plan sponsor may have to make a corrective distribution of an excess deferral or make a corrective contribution to the plan, plus earnings. To limit errors, the person in charge of determining compensation (often at a payroll processing level) must be properly trained to understand the plan document and payroll codes should be coordinated with the definition of compensation.

Section 415 of the Internal Revenue Code of 1986, as amended, provides limits on "annual additions" to defined contribution plans, including 401(k) plans. Final regulations under Section 415, which were issued by the IRS in 2007 and are effective no later than limitation years beginning on or after July

1, 2007, explicitly address the includability in compensation of amounts paid after termination of employment. Sponsors of plans which define compensation by reference to amounts reportable on Form W-2 (with certain modifications) will need to pay special heed to these regulations, as some amounts reportable on the Form W-2 of an employee for the year of his or her termination may not be includable in compensation for Section 415 purposes.

4 Missing Matching Contributions

Occasionally plan sponsors or plan administrators fail to credit the proper amount of matching contributions to a participant's account. Often this failure is due to administrative mistakes such as failing to properly count hours of service or identify plan entry dates for employees; not following plan language; or improperly computing compensation used as the basis for the match.

The timing of matching contributions can also lead to errors. For example, if a plan expresses the match formula on an annual basis but 401(k) contributions are actually matched on a per-payroll basis, some participants may not receive the full match to which they are entitled under the plan unless there is a year-end "true-up" to compare the actual matching contribution with what the match formula requires.

Matching contribution errors are minimized where plan administrators have knowledge of the match formula under the plan and have adequate and sufficient employment and payroll records to make correct calculations.

5 Failing Discrimination Testing

Unless a plan uses a safe harbor formula, it needs to be tested annually to determine whether the contributions made under the plan discriminate in favor of highly compensated employees (HCEs). These tests, the actual deferral percentage (ADP) test and the actual contribution percentage (ACP) test, assure that the amount of contributions made by and on behalf of non-highly compensated employees (NHCEs) are of a sufficient level in relation to contributions made by or on behalf of HCEs.

Plans often fail the ADP or ACP tests as a result of higher participation rates and greater deferral amounts by HCEs relative to those of the NHCE group. To guard against ADP or ACP test failure, many plans provide incentives for plan participation such as matching contributions, or use automatic enrollment or automatic increase features to enhance NHCE participation. Plans can incorrectly perform the ADP and ACP tests when NHCEs and HCEs are improperly classified, incorrect definitions of key plan terms are applied or the data used for the tests are incorrect.

When a plan fails either the ADP or ACP test, corrective action is required in order to keep the plan qualified. Plan sponsors can choose to correct a testing failure by: (i) making additional qualified non-elective contributions (QNECs) on behalf of the NHCEs (if permitted under the plan); (ii) distributing excess 401(k) contributions to HCEs; and (iii) distributing excess vested matching contributions to HCEs (or forfeiting such excess contributions if not vested).

If a plan continually fails the ADP or ACP tests, the plan sponsor should consider adopting a safe harbor plan, which relieves the testing obligation when certain stated contribution requirements are met.

6 Un-Enrolled Eligible Employees

Eligible employees should be enrolled in the plan in a timely manner based on the plan's eligibility and participation requirements as stated in the plan document. Employees are often "missed" as a result of inaccurate employee payroll data, including date of birth, date of hire and number of number of hours worked. Failure to enroll an eligible employee can lead to missed opportunities for employee deferrals as well as missed opportunities for employer matching contributions or profit sharing contributions. Eligible employees who are not provided the opportunity to participate in the plan must receive a QNEC from the employer to the plan to compensate for the missed deferral opportunity.

Annual payroll audits and review of non-enrolled employees' Forms W-2 can reveal "missed" eligible employees in an efficient manner, but some employers may need to review payroll records of non-enrolled employees during the plan year.

7 Not Properly Applying Plan Limits

Every plan must provide for certain limitations on employee contributions. The Code places an annual limit on employee pre-tax deferrals ($15,500 for 2008), and, for those employees who are 50 years of age or older, a catch-up contribution limit ($5,000 for 2008) across all plans that in which an employee participates, regardless of the employer. A plan document will typically limit the percentage of pay that may be deferred. Operationally, plans may need to limit deferrals to pass nondiscrimination testing.

Where plan or Code limits are exceeded, the excess amount plus allocable earnings must be distributed to the participant by April 15 of the year following the year in which the error occurred and any amounts not returned to the participant are subject to additional taxation. To effectively administer contribution limits, plan administrators should verify payroll information and communicate with employees who may participate in more than one 401(k) plan in a single calendar year, especially new employees hired other than as of January 1.

8 Delayed Payment of Deferrals and After-Tax Contributions to Plan

Employee pre-tax deferrals and after-tax contributions must be paid to the plan on the earliest date that the amount can be segregated from the employer's general assets; however, contributions must be made by the 15th day of the following month. Close coordination among the employer, payroll processor and the recordkeeper is needed to assure that this requirement is met.

A late contribution gives rise to a prohibited transaction under the Employee Retirement Income Security Act (ERISA) of 1974, as amended between the plan and the employer, as the employer has retained "plan assets" in the general assets of the employer, a "party in interest." Earnings must be included when late employee deferrals are made to the plan and the prohibited transaction gives rise to an excise tax. Additionally, to the extent that the plan has language regarding the timing of deposits of elective deferrals, failure to follow the terms of the plan can result. Thus, this error may result in two corrections, using EPCRS to correct the operational fault of failing to follow the plan and VFCP for the prohibited transaction.

9 Testing a Top-Heavy Plan

Some plans, particularly those sponsored by smaller employers, may need to perform a "top-heavy" test each year. This test ensures that lower-paid employees receive a minimum benefit if, during the previous year, the aggregate value of the plan accounts of "key employees" exceeds 60 percent of the aggregate value of the plan accounts of all employees under the plan.

Because the top heavy test focuses on the total value of accounts (not just contributions and deferrals made during the year), it is easier for small plans and plans with high turnover rates to be top-heavy. When a plan is top-heavy, an employer contribution of up to 3 percent of compensation must be made on behalf of all non-key employees still employed on the last day of the plan year. Plan sponsors and administrators should be aware that the definition of key employee is not the same as the definition of HCE and should be careful not to confuse the terms when performing required tests.

10 Assessing Hardship Distributions

New regulations under Section 401(k) of the Code, which must be applied effective with the plan year beginning in 2006, provide "safe harbor" guidelines for plans that offer hardship distributions to participants. The regulations list events that can result in a participant's immediate and heavy financial need, thereby triggering a request for a hardship distribution. The distribution can only be in an amount necessary to satisfy the financial need, and a hardship distribution is not available where the need can be satisfied with money from other sources.

If a hardship distribution is made when the plan does not contain appropriate provisions, or where the facts and circumstances or documentation received does not support the amount of the distribution, a qualification defect arises requiring correction under EPCRS. Employers should be familiar with the hardship provisions included in their plan document and should implement procedures to ensure that the provisions are followed in operation.

11 Keeping Up with Reporting Obligations

A plan sponsor has several, ongoing administrative duties related to the operation of a plan.

Foremost among these duties is to ensure that documents are kept up to date and, where appropriate, are filed with the federal government. Each year, plan sponsors must file a Form 5500 with the DOL. Fines for failure to file Form 5500 include both an IRS penalty ($25 per day, maximum of $15,000) and a DOL penalty ($1,100 per day, no maximum). The DFVC program offers a way to minimize penalties for late filing.

Also, plan sponsors must distribute a summary annual report (relating the plan's financial information) to participants on an annual basis. A summary plan description (SPD) must be distributed at the time of initial participation, redistributed periodically and must be provided upon request. When substantial changes are made to the plan, including changes to any information that is required to be in the SPD, a summary of material modifications must be issued to participants within 210 days after the end of the year in which the changes were adopted.

Plans that offer participant-directed investments must provide individual benefit statements at least quarterly (including required information regarding investment principles and limitations), while plans that do not permit participants to direct investment are required to provide benefit statements annually. In both cases, statements must be distributed within 45 days following the end of the applicable period. Statements must also be issued when a participant submits a written request (no more than one request in any 12-month period) and statements should automatically be provided to certain participants who have terminated service with the employer.

Finally, where a plan changes recordkeepers or investment options, a blackout notice should be provided at least 30 days (but not more than 60 days) prior to any period of three consecutive business days where the plan will be closed to participant-directed transactions.

Conclusion

The complexity of qualified retirement plans requires plan sponsors and plan administrators to devote many hours of time and extensive company resources to plan administration. Despite best efforts, not everything may go smoothly at all times.

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