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The IRS continues to improve the methodology for correcting the improper exclusion of an employee from a 401(k) plan. The recently released Revenue Procedure 2008-50 provides new guidance on the correction of such failures through the Employee Plans Compliance Resolution System.

When Opportunity Doesn't Knock

Any practitioner who works with 401(k) plans eventually will experience a plan that does not timely allow an eligible employee to make salary deferral contributions. The reason could be as simple as losing track of the next plan entry date or as complicated as neglecting to amend a plan document in conjunction with the acquisition of another company. Regardless of the reason, restricting deferrals by an otherwise eligible participant is an operational failure that can jeopardize a plan's tax-qualified status. In Revenue Procedure 2008-50, the IRS has provided new guidance to correct such failures through the Employee Plans Compliance Resolution System ("EPCRS").

There are a number of ways in which an employer may exclude an otherwise eligible employee from making salary deferral contributions. While the specific facts surrounding the error impact the correction methodology, improperly excluded employees must be made whole for the lost deferral opportunity, any related matching contribution, and the earnings thereon. Conceptually, the correction is straightforward:

- Determine the amount of missed deferrals,
- Multiply by the applicable opportunity cost factor,
- Calculate any related match,
- Adjust for investment gains/losses, and
- Deposit a QNEC equal to sum of those amounts.

It sounds simple, however, as with all qualified plan issues, the devil is in the details.

Missed Deferrals

The first step in the process, determining how much an employee would have contributed had he or she been given the opportunity, can be the most challenging. Since it is somewhat impractical for an employer to say to the excluded employee, " Tell us how much you would have contributed so we can make it up to you," EPCRS lays out the methodology for determining the amount of missed deferrals. There are several variations that impact the calculation:

- Did the employer fail to make deferrals available to the employee or did the employee make a deferral election that was not implemented?
- Is the employee an HCE or NHCE?
- Is the plan a safe-harbor 401(k) plan?
- Did the improper exclusion involve catch-up contributions?

Was There a Deferral Election?

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If the failure arose due to the employer failing to implement an employee's completed deferral election, the missed deferral is determined by applying the election to the employee's compensation for the period during which deferrals should have been withheld. [IRS Rev. Proc. 2008-50, Appendix A.05(5)(a)] If, however, no deferral election has been made, the missed deferral is based on the average deferral percentage of the group, i.e., highly compensated or non-highly compensated, in which the employee falls for the year in question. In determining the average deferral percentage for the applicable group, the plan cannot be treated as two separate plans consisting of those who are otherwise excludable and those who are not.

Example #1

Plumbers R Us, Inc. (" PRU") sponsors a 401(k) plan that allows elective deferrals and catch-up contributions up to the maximum amounts permitted by law and provides an employer matching contribution of 50 percent of the first six percent an employee defers. PRU pays its employees on a bi-weekly basis. The average deferral percentage for the Highly Compensated Employee Group is 6.5 percent, and for the Non-HCE group is 4.75 percent.

Joe is an employee of PRU who satisfies the plan's eligibility requirements and enters the plan on January 1, 2008. Joe is given election forms and completes and returns them to the Plan Administrator. Although Joe elected to defer five percent of pay when he became eligible to participate in the PRU plan, PRU did not set up the election in payroll. PRU discovered the error at the end of 2008. Joe's compensation was $60,000 for 2007 and $65,000 for 2008.

The missed deferral in this scenario is simply the amount of Joe's election (5%) multiplied by Joe's compensation during the period of exclusion ($65,000) for a total of $3,250. If Joe had elected to defer $100 per pay period instead of a percentage, the missed deferral amount is $100 multiplied by 26 pay periods for a total of $2,600.

Example #2

The facts are the same as in Example #1 except that Joe was not offered the option to defer on January 1, 2008; therefore, he has not made a deferral election.

The amount Joe would have contributed is deemed to be the average deferral percentage for the group, e.g. HCE or NHCE, in which he falls for the year of exclusion. Joe is in the Non-HCE group based on his 2007 compensation, so his missed deferral amount is deemed to be $3,087.50 or $65,000 multiplied by 4.75 percent.

What if Joe is an HCE?

Assume instead that Joe, being the entrepreneurial type, purchased ten percent of PRU from one of its retiring owners in December of 2008. The ownership stake would make Joe an HCE for 2008, so the amount of his missed deferral for that year would be 6.5 percent of his compensation or $4,225. Even if the plan uses the prior year testing method, Joe's group and applicable deferral percentage *for the period of the exclusion* are used to calculate missed deferrals.

How to Correct Safe-Harbor Plans

The missed deferral calculation for a safe-harbor 401(k) plan depends on whether the plan utilizes the matching or non-elective safe harbor. For safe-harbor match plans, the missed deferral percentage is deemed to be the greater of three percent of pay or the maximum deferral percentage that is subject to a match of 100 percent or more. The missed deferral in plans that satisfy the safe-harbor via qualified non-elective contributions is deemed to be three percent of compensation. [IRS Rev. Proc. 2008-50, Appendix A.05(2)(d)]

Example #3

PRU converts its plan to a safe-harbor match plan for 2009. Since business is booming, PRU provides an enhanced safe-harbor match of 100 percent of the first five percent deferred instead of the standard two-tiered formula. Barry, a newly eligible participant earning $75,000, is not timely enrolled in the plan.

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Since deferrals of up to five percent of pay are matched at 100 percent, Barry's missed deferral amount is deemed to be $3,750 or five percent of $75,000.

Example #4

The facts are the same as in Example #3 except PRU satisfies the safe-harbor by making a qualified non-elective contribution. Barry's missed deferrals are equal to three percent of his compensation or $2,250.

Special Adjustment for Catch-Up Eligible Participants

It is not just those who are completely excluded from making deferrals that may be entitled to a corrective contribution. If a 401(k) plan allows catch-up contributions but does not permit a participant who is otherwise eligible for the feature to take advantage of the catch-up feature, the plan sponsor must take corrective action. EPCRS provides that the missed catch-up contribution amount is deemed to be 50 percent of the catch-up contribution limit in effect for the year of the exclusion. [IRS Rev. Proc. 2008-50, Appendix A.05(4)(a)]

Example #5

John becomes eligible for the PRU plan in 2008 and elects to defer the maximum. Despite John being over age 50, PRU discontinues his deferrals when he reaches $15,500.

Since John is catch-up eligible based on his age and the fact that he has deferred the maximum under other applicable limits, PRU should not have discontinued his deferrals at $15,500. Due to this mistake, the missed catch-up contribution amount is $2,500 or half of the $5,000 catch-up limit in effect for 2008.

Opportunity Cost

Prior to 2006, an employer was required to adjust missed deferrals for investment gains or losses and deposit this amount as a QNEC. However, IRS Revenue Procedure 2006-27 introduced the premise that correction should be based on the lost opportunity for tax-preferred growth of the missed deferrals and not necessarily the total amount of missed deferrals themselves. In other words, just because a participant should have had the opportunity to make deferrals does not mean that he or she would have; it is reasonable to take the possibility of no deferral elections or deferral elections that would be terminated during the year into account when framing the correction.

The current version of EPCRS continues and expands the concept of opportunity cost. Specifically, EPCRS provides that, in the case of pre-tax and designated Roth contributions, the opportunity cost is equal to 50 percent of the amount of the missed deferrals including catch-up contributions. For voluntary after-tax contributions (other than designation Roth contributions), the opportunity cost is 40 percent of missed deferrals. [IRS Rev. Proc. 2008-50, Appendix A.05(2)(b) and (e), Appendix A.05(3)]

Example #6

In Example #1, Joe's missed deferrals based on a five percent election were equal to $3,250. Joe's lost opportunity is deemed to be half of this amount or $1,625, so PRU is required to deposit a QNEC in this amount, as adjusted for investment gains or losses.

Related Match

To the extent the plan provides for matching contributions, the improperly excluded employee must be made whole for both the missed deferral opportunity and the related match. The corrective contribution is again in the form of a QNEC and is calculated by applying the plan's matching formula (either safe-harbor or non-safe-harbor) to the amount of missed deferrals. It is important to note that when determining the corrective match amount, the calculation is not based on the opportunity cost but on the total amount of missed deferrals. [IRS Rev. Proc. 2008-50, Appendix A.05(2)(c) and (f)] It is also important to note that, notwithstanding the fact that a normal matching contribution may be subject to a vesting schedule, this corrective match must be made in the form of a fully vested QNEC.

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Example #7

Continuing with Examples #1 and #6, PRU must next determine the matching contribution to which Joe is entitled due to his improper exclusion. Joe's missed deferrals were determined to be $3,250 or five percent of his pay, and PRU's matching formula was 50 percent of the first six percent of compensation deferred. Since Joe's deferrals were within the six percent matching threshold, the corrective matching contribution is simply 50 percent of his deferrals, or $1,625. Thus, prior to any earnings adjustments, the total QNEC PRU must make to correct Joe's improper exclusion is as follows:

Deferral opportunity cost (50% of missed deferrals)	$1,625
Related matching contribution (50% of missed deferrals)	$1,625
TOTAL	$3,250

Exceptions to Full Correction

While the general rule is that an employer must make full correction when utilizing EPCRS, there are several limited exceptions in the context of the exclusion of otherwise eligible employees. First, if an eligible employee is permitted to defer for at least nine months in the plan year and is not otherwise limited in the amount he or she defers, the employer is not required to make up the opportunity cost for the three months the participant was improperly excluded. The employer is, however, required to make a QNEC representing the lost matching contribution as outlined above. [IRS Rev. Proc. 2008-50, Appendix A.05(2)(c) and (f)] Second, if the correction results in a distribution payable to a terminated participant of $75 or less and the reasonable direct cost of delivering the distribution exceeds the amount of the distribution itself, the corrective distribution is not required to be made. [IRS Rev. Proc. 2008-50, Section 6.02(5)(b)] Note, however, a participant who is either still employed or who has more than $75 in his or her account yet to be distributed must receive the corrective contribution, regardless of whether it is more or less than $75. Third, EPCRS allows the limited use of reasonable estimates when calculating missed deferrals for a portion of a year and determining related investment gains or losses. With respect to partial year exclusion, the employer can calculate missed deferrals based on pro-rated annual compensation instead of the actual amount paid to the participant during the portion of the plan year he or she was improperly excluded. [IRS Rev. Proc. 2008-50, Appendix B.02(1)(a)(ii)(E)] The calculation of lost earnings may also be based on reasonable estimates including use of the VFCP online calculator (www.dol.gov/ebsa/calculator) if precise calculation is impossible, prohibitively expensive, or the likely difference between the approximate and precise is insignificant.

Miscellaneous

Although the corrections described above address missed deferrals and related matching contributions, plan sponsors are not required to re-run the ADP and/or ACP tests as part of the correction.

It may be possible for plan sponsors to correct the exclusion of eligible employees under the Self Correction Program ("SCP"), which does not require a formal filing with and approval by the IRS. Self-correction may be used if the error happened in the current plan year or during the prior two plan years, or if the error is insignificant. If the error is significant and if it is outside the two-year correction period, it may need to be filed under the Voluntary Correction Program (" VCP"). The determination of whether the error is significant is based on a number of facts and circumstances including the number of participants affected by the error and the amount of contributions. [IRS Rev. Proc. 2008-50, Section 8.02]

Conclusion

The IRS continues to improve the methodology for correcting the improper exclusion of an employee from a 401(k) plan. Rev. Proc. 2006-27 introduced the concept of opportunity cost and reduced the QNEC from 100 percent of missed deferrals to 40 percent or 50 percent for after-tax and pre-tax deferrals, respectively. Rev.

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Proc. 2008-50 further expands the correction options by including options for designated Roth contributions and catch-up contributions as well as specifying the correction for failure to implement an employee's deferral election.

There are still several items EPCRS has not yet addressed. Section 2.02 of Rev. Proc. 2008-50 discusses future enhancements in three areas. First, comments are requested for the appropriate correction of a failure to properly implement the default deferral percentage with respect to a participant in an automatic contribution arrangement. The second area in which the IRS is seeking input is how to correct a failure to timely distribute safe harbor notices. Third, there is not presently a mechanism to correct a situation in which an employee elects to make designated Roth contributions, but the plan sponsor treats the amounts withheld as pre-tax deferrals.

Nonetheless, when an employer or participant discovers that opportunity didn't knock when it was supposed to, at least there is a useful, straightforward means to correct the error before it is the IRS that comes knocking.

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