Published on *The National Law Review* https://natlawreview.com

IRS Relaxes Correction Requirements for Elective Deferral (But Not After-Tax Contribution) Failures under EPCRS

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Less than a week after issuing significant modifications to the ***Employee Plans Compliance Resolution System (EPCRS)*** (as described in our March 31, 2015 blog), the *Internal Revenue Service (IRS)* further modified EPCRS through the release of Revenue Procedure 2015-28. The new guidance provides welcome relief (provided certain requirements are met) from the current standard (or safe harbor) EPCRS correction method for elective deferral failures, which has been widely viewed as providing affected participants with a windfall. Also, in an effort to facilitate the adoption of automatic contribution arrangements and prompt correction of failures, the IRS has established favorable safe harbor correction methods for elective deferral failures.

The most recent restatement of EPCRS, Revenue Procedure 2013-12, provides a standard correction method for elective deferral failures under 401(k) and 403(b) plans. An elective deferral failure occurs when the plan administrator fails to correctly implement a participant deferral election or automatic deferral. The current standard correction method for elective deferral failures requires a plan sponsor to make a qualified nonelective contribution (QNEC) to the plan on behalf of affected participants to compensate the participants for their missed deferral opportunity. In general, this QNEC is equal to the sum of 50% of the amount the affected participant would have deferred from pay had the elective deferrals been properly implemented (40% in the case of a failure to implement an after-tax election), plus 100% of the matching contributions the affected participant would have received, plus earnings.

Although the mantra of EPCRS is to put affected participants in the same position they would have been in had a failure not occurred, the current standard correction method is generally considered to provide a windfall in the sense that participants benefit from a “free” allocation of elective deferrals (albeit 50% of what they elected) without having to actually reduce their salary. Recognizing that the standard correction is often costly for plan sponsors, Rev. Proc. 2015-28 provides for new, relaxed safe harbor correction methods for elective deferral failures.

Interestingly, the new correction methods described in Rev. Proc. 2015-28 do not apply to failures to implement deferrals of after-tax employee contributions. For purposes of EPCRS, “elective deferrals” means pre-tax elective deferrals and separate rules are provided in Appendix A for after-tax employee contribution deferrals (although the original standard correction method is the same except for the QNEC required (50% versus 40%) for the missed contributions). The modifications to

Appendix A in Rev. Proc. 2015-28 do not mention after-tax employee contributions. Perhaps future guidance will expand the new correction methods to include after-tax employee contribution failures.

The new correction methods, and the conditions that must be met to use them, are described below.

1. Elective Deferral Failures for Plans with Automatic Contribution Features. If a plan administrator fails to implement automatic contributions when there is no election otherwise (including automatic escalation of elective deferral contributions), or fails to implement an affirmative election to contribute more than the automatic contribution rate, no QNEC equal to 50% of missed elective deferrals is required if the following conditions are met:

    - The failure does not extend beyond 9-1/2 months after the end of the plan year in which the failure first occurred.

    - Elective deferrals at the correct rate begin no later than the first payroll date following the period described above, or, if earlier, the first payroll date following the end of the month after the plan administrator receives notice of the failure from an affected participant.

    - The plan administrator sends a notice to affected participants within 45 days after the correction. This notice must include an explanation of the error and how it was corrected, a statement that a contribution has been made to compensate for missed matching contributions, a statement that the participant is able to increase his or her election to make up for missed deferrals, and contact information in the event the participant has questions.

    - A QNEC for missed matching contributions, plus earnings, is made no later than the end of the second plan year following the year in which the failure first occurred. If no affirmative investment election has been made, earnings may be determined based on the default investment option, provided that any losses cannot offset the QNEC.

It appears this safe harbor correction method is limited to elective deferrals that are tied to implementing an automatic contribution arrangement, whether an election is made or not. In other words, an election to opt-out of the automatic contribution rate in favor of a higher rate before or shortly after any deferral is made is subject to the safe harbor correction method. However, a failure based on an election to change the automatic contribution rate one year after automatic contributions commenced would not likely be eligible. In that case, the safe harbor correction methods described below or the original standard correction must be used.

This new correction method is available for eligible elective deferral failures occurring on or before December 31, 2020. The IRS will consider whether the correction method should be extended at a later date.

1. Elective Deferral Failures Unrelated to Automatic Contributions. The new guidance provides for two relaxed safe harbor correction methods for elective deferral failures unrelated to automatic contributions. Where the elective deferral failure persists for three or fewer months, no QNEC for the missed elective deferrals is needed provided the plan administrator timely corrects the failure and meets notice requirements similar to that described above. Although this correction method is more favorable than the standard correction, plan administrators

should be aware that the new guidance did not make any modifications to Appendix B of Rev. Proc. 2013-12, which contains a special rule for brief elective deferral failures. Under that special rule, if the elective deferral failure only occurs during the first three months of a plan year, no QNEC for the missed elective deferrals is necessary (a QNEC for missed matching contributions, plus earnings, is still required). The special rule does not include a notice requirement.

Where the elective deferral failure extends beyond three months, but not beyond the end of the second plan year following the plan year in which the error occurred, the failure may be corrected by making QNEC equal to 25% of the missed deferral (plus any missed matching contributions and earnings). This correction method is available if the correction is timely implemented and the plan administrator meets the notice requirements described above.

By reducing the QNEC required for the correction, the IRS is making it easier for plan sponsors to implement corrections and, thereby, incentivizing employers to adopt automatic contribution arrangements and to promptly correct elective deferral failures as they occur. The timing and notice conditions do not appear to be onerous, so overall, these modifications are certainly welcome. Rev. Proc. 2015-28 does not supersede Rev. Proc. 2013-12, so plan administrators should ensure compliance with Rev. Proc. 2013-12, subject to the modifications described above and in Revenue Procedure 2015-27, when implementing any correction.

National Law Review, Volume V, Number 96