401(k) Plan Fix-It Guide

Mistake	Find the Mistake	Fix the Mistake	Avoid the Mistake
1) You haven't updated your plan document within the past few years to reflect recent law changes. (More)	Review the annual cumulative list to see if the plan has all required law changes (see Notice 2013-84).	Adopt amendments for missed law changes. If you missed the deadline to adopt an amendment you may need to use the IRS correction program.	Use a calendar that notes when you must complete amendments. Review your plan document annually. Maintain regular contact with the company that sold you the plan.
2) You didn't base the plan operations on the terms of the plan document. Failure to follow plan terms is a very common mistake. (More)	Conduct an independent review of the plan document provisions compared to its operation.	Apply reasonable correction method that would place affected participants in the position they would've been in if there were no operational plan defects.	Develop a communication mechanism to make all relevant parties aware of changes on a timely and accurate basis (best practices). Perform a review at least annually to ensure that you're following plan terms.
3) You didn't use the plan definition of compensation correctly for all deferrals and allocations. (More)	Review the plan document definition of compensation used for determining elective deferrals, employer nonelective and matching contributions, maximum annual additions and top-heavy minimum contributions. Review the plan election forms to determine if they're consistent with plan terms.	Corrective contribution or distribution.	Perform annual reviews of compensation definitions and ensure that the person in charge of determining compensation is properly trained to understand the plan document.
4) Employer matching contributions weren't made to all appropriate employees. (More)	Review the plan document to determine the employee eligibility requirements and matching contribution formula. Compare it to what's used in operation.	Apply a reasonable correction method that would put affected participants in the same position they would've been in if there were no operational plan defects.	Contact plan administrators to ensure that they have adequate employment and payroll records to make calculations.
5) The plan failed the 401(k) ADP and ACP nondiscrimination tests. (More)	Conduct an independent review to determine if highly and nonhighly employees are properly classified.	Make qualified nonelective contributions for the nonhighly compensated employees.	Consider a safe harbor or automatic enrollment plan design. Communicate with plan administrators to ensure proper employee classification and compliance with the plan terms.

Mistake	Find the Mistake	Fix the Mistake	Avoid the Mistake
6) Eligible employees weren't given the opportunity to make an elective deferral (exclusion of eligible employees). (More)	Review the plan document sections on eligibility and participation. Check with plan administrators to determine when employees are entering the plan.	Make a qualified nonelective contribution for the employee that compensates for the missed deferral opportunity.	Monitor census information and apply participation requirements.
7) Elective deferrals weren't limited to the amounts under IRC Section 402(g) for the calendar year and excess deferrals weren't distributed. (More)	Inspect deferral amounts for plan participants to ensure that the employee hasn't exceeded the limits.	Distribute excess deferrals.	Work with plan administrators to ensure that they have sufficient payroll information to verify the deferral limitations of IRC Section 402(g) were satisfied.
8) You haven't timely deposited employee elective deferrals. (More)	Determine the earliest date you can segregate deferrals from general assets. Compare that date with the actual deposit date and any plan document requirements.	Usually corrected through DOL's Voluntary Fiduciary Correction Program. You may also need to correct through the IRS correction program. Deposit all elective deferrals withheld and earnings resulting from the late deposit into the plan's trust	Coordinate with your payroll provider to determine the earliest date you can reasonably segregate the deferral deposits from general assets. Set up procedures to ensure that you make deposits by that date.
9) Participant loans don't conform to the requirements of the plan document and IRC Section 72(p). (More)	Review the plan document and all outstanding loans to ensure that the loans comply with the plan terms and that employees are repaying their loans timely.	You may correct some failures by corrective repayment and/or modification of loan terms.	Review and follow the plan provisions on loans, including the loan amount, term of the loan and repayment terms. Ensure that there are procedures in place to prevent loans that are prohibited transactions.
10) Hardship distributions weren't made properly. (More)	Review all in-service distributions and determine whether hardship distributions met the plan requirements.	Amend plan retroactively to allow for hardship distributions. If impermissible hardship distribution, have participant return hardship distribution amount plus earnings.	Be familiar with your plan document's hardship provisions and ensure that you follow the provisions in operation. Ensure that your plan administrators and payroll offices share the plan's hardship distribution information.
11) The plan was top-heavy and required minimum contributions weren't made to the plan. (More)	Review the rules and definitions for top-heavy found in your plan document. Determine whether your plan is top-heavy for the plan year.	Properly contribute and allocate the required top-heavy minimum, adjusted for earnings, to the affected non-key employees.	Perform a top-heavy test each year.

Mistake	Find the Mistake	Fix the Mistake	Avoid the Mistake
12) You haven't filed a Form 5500-series return this year. (More)	Find your signed copy of the return and determine if you filed it timely.	File all delinquent returns.	Understand your filing requirement and know who filed and when. Don't assume someone else is taking care of it.

401(k) Plan - Overview

Generally, Internal Revenue Code Section 401(k) permits an employee to elect to have the employer contribute a portion of the employee's wages to a 401(k) plan on a pre-tax basis (these employee contributions are known as elective deferrals, salary deferrals or salary reduction contributions). A 401(k) plan is also referred to as a cash or deferred arrangement, or CODA. A 401(k) plan may also include other types of employer and employee contributions.

Elective deferrals (other than designated Roth contributions) aren't subject to federal income tax withholding at the time of deferral and they aren't reflected as income on the employee's Form 1040, *U.S. Individual Income Tax Return*.

Example: Jan earns $25,000 in a year and elects to defer $3,000 into a 401(k) plan. Jan will only include $22,000 as income on that year's tax return.

Although the law doesn't treat amounts deferred as current income for federal income tax purposes, they are included as wages subject to Social Security (FICA), Medicare and federal unemployment taxes (FUTA). Additionally, elective deferrals are always 100% vested, or fully owned by the employee.

A 401(k) plan is a "qualified plan" - one that satisfies the requirements listed under Internal Revenue Code Section 401(a). If a plan satisfies these requirements, plan contributions made by the employer may be currently deductible and these contributions ordinarily won't be included in employees' gross income until distributed from the plan. If a plan fails to satisfy any of the Section 401(a) requirements, the plan becomes "disqualified" and the favorable tax benefits associated with these plans may be lost.

There are several types of 401(k) plans available to employers:

- traditional 401(k) plans,
- safe harbor 401(k) plans, and
- SIMPLE 401(k) plans.

Different rules apply to each. The following is a brief description of each type of 401(k) plan:

Traditional 401(k) plans allow employees who've met the plan eligibility requirements to make pre-tax elective deferrals or designated Roth contributions through payroll deductions (elective deferrals). Additionally, employers have the option of contributing for all eligible employees matching contributions based on employees' elective deferrals, other nonelective employer contributions or any combination of these contributions. These employer contributions can be subject to a vesting schedule, which provides that after a period of time an employee's right to employer contributions becomes nonforfeitable, or they can be immediately vested. Rules relating to traditional 401(k) plans require that plan contributions meet specific nondiscrimination requirements. To ensure that the plan satisfies these requirements, the employer must perform annual tests, called the actual deferral percentage and actual contribution percentage tests, to verify that elective deferrals and employer matching contributions don't discriminate in favor of highly compensated employees.

Plan sponsors can increase participation in 401(k) plans by adding an automatic enrollment feature to a traditional 401(k) plan. An eligible automatic contribution arrangement allows a participant to withdraw automatic enrollment elective deferrals within 90 days of the first contribution made for the participant without incurring an additional 10% tax under IRC Section 72(t). The EACA provides a participant with a window to reconsider automatic enrollment deferrals. Any amounts withdrawn aren't considered in the ADP test and any matching contributions forfeited because of the withdrawn amounts aren't considered in the ACP test. Another advantage of the EACA is that, if all eligible employees are covered by the EACA, excess contributions and excess aggregate contributions may be distributed within 6 months (instead of 2 ½ months for other 401(k) plans) after the end of the plan year and avoid the excise tax on excess contributions under IRC Section 4979.

Plans with the automatic enrollment feature must take steps to ensure that amounts are withheld in a timely manner. For a discussion on finding, fixing and avoiding this mistake, see "Fixing Common Plan Mistakes - Correcting a Failure to Implement the Plan's Automatic Enrollment Provisions."

Safe harbor 401(k) plans are similar to traditional 401(k) plans; however, if the plan meets the safe harbor requirements under IRC Section 401(k)(12), the employer doesn't have to perform the annual ADP or ACP nondiscrimination tests that apply to traditional 401(k) plans. With the safe harbor option under IRC Section 401(k)(12), plan sponsors may choose one of two safe harbor designs, each with their own set of rules. The second option has an automatic contribution feature that satisfies the requirements under IRC Section 401(k)(13) and is referred to as a qualified automatic contribution arrangement (QACA).

The ADP test requirement is considered satisfied under both safe harbor options if:

(1) a prescribed level of safe harbor matching or nonelective contributions is made for all eligible nonhighly compensated employees, and
(2) employees are provided with a timely notice describing their rights and obligations under the plan.

Matching contributions made to satisfy the ADP safe harbor requirement are also considered for satisfying the ACP test. Other matching contributions (not used for satisfying the ADP safe harbor) are generally subject to the ACP test unless the plan meets certain other requirements. The ADP safe harbor matching contribution requirements, however, are different for each of the safe harbor options. Both safe harbor options provide that, instead of the matching contribution, a plan can satisfy the ADP safe harbor requirement by making a nonelective contribution of at least 3% of compensation for each eligible nonhighly compensated employee.

The key areas where the two safe harbor options differ are:

(1) **Automatic enrollment feature**: A plan designed to satisfy the safe harbor option under IRC Section 401(k)(12) isn't required to provide for an automatic enrollment feature. On the other hand, a safe harbor option under IRC Section 401(k)(13), a QACA, must provide for an automatic enrollment feature. Under that feature, unless employees affirmatively elect otherwise, they're treated as if they elected to have the employer make elective contributions equal to no less than:

    - 3% of compensation for the initial period,
    - 4% for the plan year following the initial period,
    - 5% for the next plan year, and
    - 6% for the years that follow.

    An employer may set the automatic contribution amount at a percentage higher than the minimums, but no higher than 10% of compensation. The QACA notice provided to participants must explain the employee's right to opt out and not have elective contributions made or elect to have the contributions made at a different percentage. The notice should also explain how the contributions will be invested in the absence of any specific investment direction by the employee.

(2) **ADP safe harbor matching contributions**: Matching contributions made for an employee for satisfying the safe harbor requirement under IRC Section 401(k)(12) should, for each level of an employee's deferral, be at least:

- 100% of elective contributions that do not exceed 3% of compensation, plus
- 50% of elective contributions between 3% and 5% of compensation.

In a QACA, the ADP safe harbor matching contribution made for an employee should, for each level of an employee's deferral, be at least:

- 100% of elective contributions that do not exceed 1% of compensation, plus
- 50% of elective contributions between 1% and 6% of compensation.

(3) **Vesting of employer contributions made to satisfy the ADP safe harbor requirement**: In a plan designed to satisfy the requirements of IRC Section 401(k)(12), employees must be fully vested in ADP safe harbor contributions made for them.

In a QACA, the plan could require that employees complete two years of vesting service before they can be vested in the ADP safe harbor contributions.

Employers sponsoring safe harbor 401(k) plans must also provide each eligible employee with written notice of the employee's rights and obligations under the plan. This notice must describe the safe harbor method used, how eligible employees make elections and any other plans involved.

Generally, the employer must provide the notice within a reasonable period – between 30 and 90 days before the beginning of each plan year.

SIMPLE 401(k) plans aren't subject to the annual ADP and ACP nondiscrimination tests that apply to traditional 401(k) plans. Similar to a safe harbor 401(k) plan, the employer is required to make employer contributions that are fully vested. This type of 401(k) plan is only available to employers with 100 or fewer employees who received at least $5,000 in compensation from the employer for the prior calendar year. In addition, employees covered by a SIMPLE 401(k) plan may not receive contributions or benefit accruals under any other plans of the employer.

Employee Plans Compliance Resolution System (EPCRS) – Overview

If you make mistakes with respect to your 401(k) plan, you may use the IRS Employee Plans Compliance Resolution System to remedy your mistakes and avoid the consequences of plan disqualification. A correction for a mistake should be reasonable and appropriate. The correction method should resemble one already outlined in the Code and you should consider all applicable facts and circumstances. Revenue Procedure 2013-12, 2013-4 I.R.B. 313 is the official guidance governing the EPCRS program.

There are three ways to correct mistakes under EPCRS:

1) **Self-Correction Program** **(SCP)** - permits a plan sponsor to correct certain plan failures without contacting the IRS.
2) **Voluntary Correction Program** **(VCP)** - permits a plan sponsor to, any time before audit, pay a limited fee and receive IRS approval for correction of plan failures.
3) **Audit Closing Agreement Program** **(Audit CAP)** - permits a plan sponsor to pay a sanction and correct a plan failure while the plan is under audit.

A general description of each component of EPCRS is provided below:

Self-Correction Program:

- To be eligible for SCP, the plan sponsor or administrator must have established practices and procedures (formal or informal) reasonably designed to promote and facilitate overall compliance with the law. A plan document alone does not constitute evidence of established procedures.
- SCP is available for correcting operational problems only – that is, the failure to follow the plan terms. SCP is not available for problems with the plan document, such as the failure to keep your plan document current to reflect changes in the law.
- The plan sponsor corrects using the general correction principles in Revenue Procedure 2013-12.
- A plan sponsor that corrects a failure listed in Appendix A or Appendix B of Revenue Procedure 2013-12 according to the correction methods listed may be certain that their correction is reasonable and appropriate for the failure.
- If needed, the plan sponsor should make changes to its administrative procedures to ensure that the mistakes do not recur.
- A plan sponsor may correct significant operational failures within two years of the end of the plan year in which the operational failures occurred.
- SCP may be used if, considering all of the facts and circumstances, the mistakes, in the aggregate, are insignificant operational failures.
- When using SCP, the plan sponsor should maintain adequate records to demonstrate correction in the event of an audit of the plan.
- There is no fee for self-correction.

Voluntary Correction Program:

- The plan sponsor:
    1) completes forms 8950 and 8951.
    2) identifies the mistakes.
    3) proposes correction using the general correction principles in Revenue Procedure 2013-12, section 6.
    4) proposes changes to its administrative procedures to ensure that the mistakes do not recur.

5) pays a compliance fee that generally is based on the number of plan participants reported on the most recently filed Form 5500-series return:

Number of Plan Participants	Compliance Fee
o 20 or fewer	o $ 750
o 21 to 50	o $ 1,000
o 51 to 100	o $ 2,500
o 101 to 500	o $ 5,000
o 501 to 1,000	o $ 8,000
o 1,001 to 5,000	o $15,000
o 5,001 to 10,000	o $20,000
o Over 10,000	o $25,000

- The IRS issues a Compliance Statement detailing the mistakes identified by the employer and correction methods approved by the IRS.
- The plan sponsor corrects the identified mistakes within 150 days of the issuance of the Compliance Statement.
- While the IRS is processing the submission, IRS will not audit the plan, except under unusual circumstances.

Audit Closing Agreement Program:

- The plan sponsor or plan is under audit.
- The plan sponsor:
    1) enters into a Closing Agreement with the IRS.
    2) makes correction prior to entering into the Closing Agreement.
    3) pays a sanction negotiated with the IRS.
        - The sanction paid under Audit CAP should be greater than the fee paid under VCP.
- The sanction under Audit CAP is a negotiated percentage of the **Maximum Payment Amount** based on the sum for all open taxable years of the:
    1) tax on the trust (Form 1041) (and any interest and penalties on the trust tax return).
    2) additional income tax resulting from the loss of employer deductions for plan contributions (and any interest and penalties on the plan sponsor's tax return).
    3) additional income tax resulting from income inclusion for participants in the plan (Form 1040), including the tax on plan distributions that have been rolled over to other qualified trusts (and any interest and penalties on the participants' tax returns).

Return to Table

Mistake	Find the Mistake	Fix the Mistake	Avoid the Mistake
You haven't updated your plan document within the past few years to reflect recent law changes.	Review the annual cumulative list to see if the plan has all required law changes (see Notice 2013-84).	Adopt amendments for missed law changes. If you missed the deadline to adopt an amendment you may need to use the IRS correction program.	Use a calendar that notes when you must complete amendments. Review your plan document annually. Maintain regular contact with the company that sold you the plan.

1) You haven't updated your plan document within the past few years to reflect recent law changes.

All 401(k) plans must be established and supported by a formal written plan document that complies with the Internal Revenue Code. You must amend your written plan when the tax laws affecting 401(k) plans change. The IRS generally establishes a firm deadline by which plan amendments reflecting tax law changes must be adopted. This requirement applies to all 401(k) plans, whether active or not, for as long as assets remain in the plan. Terminating plans must be updated for law changes through the date of termination.

How to find the mistake:

As a 401(k) plan sponsor, you need to be able to show that:

- you've timely adopted:
  - a written plan document, and
  - any necessary amendments to reflect tax law changes; and
- the plan document complies with the form requirements of the IRC.

You should review the following documents to determine if you timely amended your plan:

- Original plan document
- All subsequent plan amendments or restatements
- Any adoption agreements (The adoption agreement isn't the complete plan document and must be accompanied by a basic plan document, which provides details of how the plan must operate.)
- Any IRS opinion or advisory letter
- Any IRS determination letter
- Board of Director's resolutions and minutes, or similar records related to the plan

Types of plan documents

You may have a written plan document that is:

- a pre-approved plan or
- an individually designed plan

The two main types of pre-approved plans are:

- Master & Prototype plans and
- Volume Submitter plans.

M&P sponsors and VS practitioners submit these respective plans to obtain an IRS opinion or advisory letter approving the form of the plan document. You may adopt a pre-approved plan from an M&P sponsor or VS practitioner. An individually designed plan document is tailored to meet the particular needs of an employer by providing the maximum amount of flexibility in plan design. The IRS hasn't pre-reviewed it.

Updating plan documents

401(k) plans must be updated from time-to-time to conform to changes in the federal tax laws made by Congress or to reflect official guidance issued by the IRS. If you didn't adopt an amendment on a timely basis, you are a late amender or a nonamender, which means your 401(k) plan doesn't comply with the law and is no longer a tax-favored qualified plan.

Plans have to be amended by the end of their remedial amendment cycles. To take advantage of its RAC, the plan sponsor must have adopted annual interim amendments by the end of the year in which the law changes became effective.

[Revenue Procedure 2007-44] requires 401(k) plans to be amended and restated every [five years] for individually designed plans (or six years for pre-approved plans)**.** This guidance also establishes deadlines for interim and discretionary plan amendments and provides guidance on when plan sponsors may submit determination letter applications to the IRS using a revolving cycle system. Under that system, individually designed plans are assigned a specific five-year cycle (Cycles A-E), which is generally based on the last digit of the plan sponsor's EIN. If you use a pre-approved plan document, the institution that maintains the plan document should contact you when you need to update the plan.

Interim and good faith amendments are required to keep a written plan document current between remedial amendment cycles. Other amendments are **discretionary amendments**. Plan sponsors must usually adopt:

- an interim amendment by the later of the:
    - due date (including extensions) for filing the income tax return for the employer's taxable year that includes the date on which the amendment is effective, or
    - last day of the plan year that includes the date on which the amendment is effective.
- a discretionary amendment by the end of the plan year in which the plan amendment is effective.

An interim amendment doesn't include any amendment adopted to:

- correct a mistake to operate the plan according to the plan terms.
- comply with legislation for which the remedial amendment period has already expired.

Example 1:

A plan provides for a 6-year graded vesting schedule and the plan operated on a 5-year vesting schedule. A corrective amendment providing for a 5-year vesting schedule isn't an interim amendment.

Example 2:

An amendment adopted to bring a plan into compliance with GUST or any other previous legislation isn't a good faith or interim amendment.

Cumulative List

The IRS publishes a Cumulative List of Changes in Plan Qualification Requirements near the end of each year. It will help you determine which interim amendments you need to adopt and which amendments have to be finalized in your plan by the end of your current 5-year cycle. The most current Cumulative List, in [Notice 2013-84], is for Cycle D plan sponsors and individually-designed multiemployer plans to use to draft their plans for the submission period ending January 31, 2015.

The following table summarizes some of the major tax laws and IRS guidance enacted or issued after 2001 that apply to 401(k) plans and where the plan amendment deadline has expired. This isn't a complete or comprehensive list. For a more detailed list of changes, refer to the applicable Cumulative List for your plan. It may be important to review the initial Cumulative List that applied to your plan, since the cumulative lists for the second cycle series don't include amendment items from the initial cycle.

Tax Law **IRS Guidance**	**Major Provisions**	**Amendment Deadlines***
Small Business Jobs Act of 2010	Participants in a 401(k) plan were allowed to convert their vested 401(k) accounts to Roth accounts without taking a distribution from the plan.	The later of: • the last day of the plan year in which the amendment was effective, or • December 31, 2011 If your plan didn't implement this benefit in operation, then no plan amendment was necessary (see Notice 2010-84).

Worker, Retiree, and Employer Recovery Act of 2008 (WRERA)	• Allowed required minimum distributions associated with the 2009 calendar year to be suspended or reduced.
	• Distributions made on or after January 1, 2010, must allow for non-spouse beneficiary distributions via direct rollover.
	• Retroactive technical corrections to PPA.
		• RMD provision – The amendment deadline is generally the last day of the first plan year that began on or after January 1, 2011.
		If your plan didn't suspend or reduce RMDs during 2009, then no plan amendment was necessary (see Notice 2009-82).
		• Distribution requirement – The amendment deadline is generally the filing deadline for the plan sponsor's 2010 tax return.
		• However, the deadline was January 31, 2011 for plan sponsors:
		  • who use an individually designed plan, and
		  • whose EIN ends in 5 or 0.
		Amendment deadline for PPA technical corrections was by the end of the 2009 plan year. For calendar year plans, the deadline was December 31, 2009.

Heroes Earnings Assistance and Relief Tax Act Of 2008 (HEART)	Requires all 401(k) plans to be amended for special benefits for plan participants who are or who may perform qualified military service.	The last day of the first plan year that began on or after January 1, 2010. For calendar year plans, the deadline was December 31, 2010.

Tax Law IRS Guidance	Major Provisions	Amendment Deadlines*
Pension Protection Act of 2006 (PPA)	Requires faster vesting of employer contributions, simplifies 401(k) administration, diversification of plan investments, increased portability for distributions. Permits additional new automatic contribution arrangements and other optional benefits. Temporary provisions of a 2001 tax law change were made permanent.	The last day of the first plan year that began on or after January 1, 2009. For calendar year plans, the deadline was December 31, 2009. Specific PPA amendments on the diversification of investments didn't have to be adopted until the end of the first plan year that began on or after January 1, 2010 (see Notice 2009-97). For calendar year plans, the deadline for this specific item was December 31, 2010.
Final IRC Section 415 regulations	Numerous changes to plan language associated with IRC Section 415(c) effective for limitation years beginning on or after July 1, 2007.	The later of: • the last day of the plan year in which the amendment was effective, or • the extended due date of the employer's tax return for the year which includes the effective date. For many plans, the amendment deadline was the filing deadline for the plan sponsor's 2008 tax return. The deadline may be earlier if your plan has a non-calendar plan year, limitation year or both. The deadline was January 31, 2009 for plan sponsors: • who use an individually designed plan, and • whose EIN ends in 3 or 8.
Final IRC Sections 401(k) and 401(m) regulations	Made changes to 401(k) administration and was mandatorily effective for plan years beginning on or after January 1, 2006.	For many plans, the filing deadline for the plan sponsor's 2006 tax return. However, some plan sponsors who use an individually designed plan and fall under Cycle A or B had an earlier deadline. If the regulations were optionally applied in 2005, the amendment needed to be adopted by December 31, 2005.
Automatic rollover provision associated with IRC Section 401(a)(31)(B) and Notice 2005-5	Changes to the rules related to mandatory distributions of benefits. Applies to all plans on or after March 25, 2005.	The later of: • December 31, 2005, or • the filing deadline of the plan sponsor's 2005 tax return.

Tax Law IRS Guidance	Major Provisions	Amendment Deadlines*
Final IRC Section 401(a)(9) regulations	Various changes to the rules regarding required minimum distributions. Applies to all plans starting in 2003.	Good faith amendment generally needed to be adopted by the last day of the first plan year that began on or after January 1, 2003. If good faith amendments were timely adopted, a restated plan document that fixed any defects or minor omissions needed to be adopted by the end of the plan sponsor's cycle that included EGTRRA as set forth in Revenue Procedure 2007-44. For plan sponsors who use pre-approved plans, the end of the applicable remedial amendment period was April 30, 2010 (see Announcement 2008-23).
Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)	Provided for higher benefits and simplification of plan administration. Generally effective in 2002.	Good faith amendments generally needed to be adopted by the last day of the first plan year that began on or after January 1, 2002. If you used a pre-approved plan document, the deadline was September 30, 2003. Assuming the good faith amendments were timely adopted, a restated plan document that complied with all EGTRRA requirements and that fixed any defects or minor omissions needed to be adopted by the end of the plan sponsor's cycle that included EGTRRA as set forth in Revenue Procedure 2007-44. For plan sponsors who use pre-approved plans, the end of the applicable remedial amendment period was April 30, 2010 (see Announcement 2008-23).

* Special grandfathered 401(k) plans sponsored by a governmental entity as defined in IRC Section 414(d) may have had later deadlines, in some cases, than the ones specified in the table for some of the listed amendments.

How to fix the mistake:

Corrective action:

If you find you haven't amended your plan timely for law changes, you should take the following steps:

- Adopt amendments for the tax law changes you've missed. You may be able to use IRS model or sample amendments that apply to your 401(k) plan. You'll need to confirm that the operation of the plan is consistent with the plan terms, including the amendment. For individually designed plans, the IRS has published some suggested sample language as part of a package of Listing of Required Modifications.

- Model amendments issued by the IRS may be useful. The following IRS guidance contains model or sample plan amendments:
  - Sample amendment to provide for designated Roth contributions in 401(k) plans (Notice 2006-44).
  - Sample amendments to add the automatic enrollment feature (Notice 2009-65).
    - Use Sample Amendment 1 to add an automatic contribution arrangement to a 401(k) plan.
    - Use Sample Amendment 2 to add an eligible automatic contribution arrangement described in IRC Section 414(w) (permitting 90-day withdrawals) to a 401(k) plan.
- You may have to adopt a pre-approved plan from an M&P sponsor or VS practitioner.
- Generally, the effective date of the amendment should be retroactive to conform the plan's terms to the requirements of the legislation.
- File a VCP submission with the IRS using Revenue Procedure 2013-12.

If the only mistake in the VCP submission involves the late adoption of interim amendments or amendments required to implement an optional law change, then the plan sponsor can use Revenue Procedure Appendix C - Part I and Schedule 1, including Forms 8950 and 8951. The resolution of certain interim or optional law change amendment failures using Schedule 1 results in the IRS treating the corrective amendment as if the plan sponsor had adopted it timely to determine the availability of the extended remedial amendment period. The fee for the submission is $375.

Schedule 1 isn't available if the required or optional law change amendment isn't adopted before the plan's extended RAP expires. If the amendment is adopted after the expiration of the RAP, then the plan sponsor should use Schedule 2 to describe the plan document failure. In that case, check the box indicating that the plan wasn't timely amended for the Cumulative List that included the late good faith/interim amendment.

Correction programs available:

Self-Correction Program:
This mistake cannot be corrected under SCP.

Voluntary Correction Program:
If the plan isn't under examination, you may make a VCP submission to the IRS. There is a fee for this mistake.

Example 1:
The XYZ Company maintains a pre-approved 401(k) plan using the calendar year as its plan year. The 2010 Form 5500 indicated that the plan had 40 participants. In 2011, the plan administrator determined that the XYZ Company didn't adopt interim amendments associated with PPA by December 31, 2009 as required by their pre-approved plan's provider. Since the special remedial amendment period for pre-approved plans that includes the PPA changes is still considered open in 2011 when the VCP submission is filed with the IRS, this problem is considered a late interim amendment failure. The fee for this size plan would normally be $1,000; however, if the failure to adopt timely interim amendments is the only mistake in the submission, there is a reduced fee of $375 regardless of the number of participants in the plan. XYZ Company should use Appendix C - Part 1 of and Schedule 1 when preparing its VCP submission. Note: XYZ must list all specific late PPA amendments on Schedule 1 and complete Forms 8950 and 8951.

Example 2:
Same facts as Example 1, except XYZ Company didn't timely amend its plan for changes in the law mandated by EGTRRA. XYZ Company should've adopted EGTRRA good faith amendments by September 30, 2003. In addition, most pre-approved document providers required their clients to adopt an EGTRRA pre-approved restated plan document by April 30, 2010, to be considered timely amended. XYZ Company may use Appendix C - Part I and Schedule 2 of Revenue Procedure 2013-12. The VCP fee is $1,000. Note: If you use a pre-approved plan and didn't timely amend for EGTRRA, consult the VCP Submission Kit.

Example 3:
ABC Corporation sponsors a 401(k) plan and uses an individually designed plan document. ABC's EIN ends in three and, therefore, falls under Cycle C, which is associated with the 2012 Cumulative List. The remedial amendment period for this cycle ended on January 31, 2014, assuming ABC adopted all good faith/interim amendments timely. The 2013 Form 5500 indicated that the plan had 450 participants. After January 31, 2014, ABC's plan consultants determined that ABC didn't adopt interim amendments for PPA by January 31, 2014. In addition, these provisions weren't adopted in any form by January 31, 2014. The consultants also found additional defective plan language. Because the remedial amendment cycle that includes PPA closed before ABC adopted the amendments, this failure isn't eligible for the reduced $375 fee. ABC must use Appendix C Part II Schedule 2 and check the box indicating that the plan wasn't timely amended for the 2012 Cumulative List.

The fee in this case is generally $5,000; however, if the only mistake was being a late amender for Cycle C (due date/end of remedial amendment cycle was January 31, 2014) and ABC filed a VCP submission within one year of the end of Cycle C (by January 31, 2015), then the VCP fee would be 50% of the normal fee in the chart, or $2,500 ($5,000 x 50% = $2,500).

Audit Closing Agreement Program:
If this mistake is found on audit, you may correct it under Audit CAP. The sanction under Audit CAP is a percentage of the maximum payment amount.

If an IRS agent finds this mistake during the determination letter process, it's subject to a higher fee than if you bring the mistake to the agent's attention in the application. If you've filed for a determination letter and discover you may be a nonamender, bring this to the agent's attention to avoid the higher fee.

How to avoid the mistake:

- Do an annual review of your plan document.
- Identify a person responsible for determining when time-sensitive plan amendments must be adopted, and informing all relevant parties when regulatory changes will impact the plan and require amendments. Use a calendar (tickler file) that notes when you must complete amendments.
- Make sure your plan document and Summary Plan Description or Summary of Material Modifications, as relevant, match. If you amend your plan document, check the language against the old plan document, noting any differences. Have a centralized person or department responsible for maintaining all plan documents.
- Ensure that amendments are readily available for all plans including those transferred, merged, spun-off, or transferred in a trust-to-trust transfer to the plans —back to the later of the last determination letter issued directly to the employer or to inception.
- Maintain contact (at least annually) with the outside professionals, who have drafted the plan documents, or the service provider that sponsors or sold your company the

prototype or volume submitter plan documents. If the service provider, bank, or law firm sends a set of amendments to formally adopt, make certain that it's timely executed per the sender's instructions. Keep signed, dated copies of all plan documents and any amendments for your records. Knowing you've properly updated your plan may not be a simple process. Certain plans must be individually amended for each change, while others may have a prototype document that's amended by the external service provider.

Return to Table

Mistake	Find the Mistake	Fix the Mistake	Avoid the Mistake
You didn't base the plan operations on the terms of the plan document. Failure to follow plan terms is a very common mistake.	Conduct an independent review of the plan document provisions compared to its operation.	Apply reasonable correction method that would place affected participants in the position they would've been in if there were no operational plan defects.	Develop a communication mechanism to make all relevant parties aware of changes on a timely and accurate basis (best practices). Perform a review at least annually to ensure that you're following plan terms

2) You didn't base the plan operations on the terms of the plan document.

The plan sponsor/employer is responsible for keeping the plan in compliance with the tax laws; however, there may be many employees, vendors and tax professionals servicing your plan.

You should convey any changes made to your plan document or to your plan's operation to everyone who provides service to your plan. For example, if you amend your plan document to change the definition of compensation, you should communicate that change to everyone involved in determining deferral amounts withheld from employee pay, performing your plan's nondiscrimination tests or allocating employer contributions. Also, if you decide to use a different definition of compensation in operation, make sure you amend the plan timely to reflect that change. Below are some common changes requiring due diligence to identify any potential mistakes:

- If you made changes to your plan document, inform everyone who services your plan of those changes and what the changes mean to your plan's operation.
- If you amend your plan document, you should also amend your summary plan description. If you materially modify your plan, you must give a summary of the material modifications to plan participants within 210 days after the end of the plan year in which you adopted the modification.
- If you've changed the way you operate your plan, communicate those changes to everyone who provides service to your plan. You may need to reflect these changes to your plan document through a plan amendment.
- If you've changed the plan trustees, you need to convey those changes and you may need to update your plan document and summary plan description.
- Any changes in the ownership interests or business acquisitions may affect the nondiscrimination testing for the plan. Convey these changes to your plan service providers.

How to find the mistake:

You must be familiar with your plan document to be able to determine if you've operated it according to its terms. Following the plan document terms is crucial to ensure tax-favored treatment of the plan and to prevent a breach of fiduciary duty under ERISA. Be familiar with the plan document wording and how it affects the plan operation. Conduct an independent review of your plan and its operation annually. If you operate your plan using a summary, check the requirements and definitions on that sheet to make certain they correspond to the plan document. Consider conducting a 401(k) plan check-up using the 401(k) plan checklist.

How to fix the mistake:

Corrective action:
If you find an error in the operation of your plan, correct it as soon as possible. Use a reasonable correction method that places affected participants in the same position they would have been in had the mistake not occurred. Revenue Procedure 2013-12, section 6 provides general correction principles you should use in determining an appropriate correction method. If you correct a mistake listed in Appendix A or Appendix B of Revenue Procedure 2013-12 according to the correction methods provided, you may be certain that your correction is acceptable.

Example:
Employer A's 401(k) plan provides for employer matching contributions of 50% of the deferrals made to the plan, up to the first 6% of compensation. The plan provides that these employer-matching contributions vest at the rate of 20% per year. There are 75 participants in the plan**.** A participant must work at least 1,000 hours in a calendar year to receive vesting credit for that year. Bob participated in the plan from January 1, 2009, to September 30, 2012, when he terminated employment. Bob worked 2,000 hours in 2009, 2010 and 2011, and during 2012, the year of termination, Bob worked 1,100 hours. At termination, Employer A paid Bob his plan benefits in a lump sum. At that time, Bob's employer matching contribution account balance was $5,000. Employer A calculated Bob's vested percentage as 60%, 20% for each of the three full calendar years he was employed. Bob was paid $3,000 from his employer matching contribution account.

A mistake has occurred because Employer A should've credited Bob with a vesting year of service for 2012 since he worked in excess of 1,000 hours in that plan year. Bob should've been 80% vested for the four years of vesting service.

Reasonable correction:
Employer A must make a corrective distribution to Bob to correct the vesting mistake. Employer A should credit Bob with an additional 20% of the account balance of $5,000, or $1,000, plus any additional earnings from the date of the original distribution to the date of the corrective distribution.

Correction programs available:

Self-Correction Program:
The example illustrates an operational problem, because Employer A didn't follow the plan terms by improperly vesting Bob's account. If the other eligibility requirements of SCP are satisfied, Employer A may use SCP to correct the mistake.

- No fees for self-correction.
- Practices and procedures must be in place.
- If the mistakes are **significant** in the aggregate:
    - Employer A needs to make corrective distribution by December 31, 2014.
    - If not corrected by December 31, 2014, Employer A isn't eligible for SCP and must correct under VCP.
- If the mistakes are **insignificant** in the aggregate, Employer A can make a corrective distribution beyond the two-year correction period for significant errors. Whether a mistake is insignificant depends on all facts and circumstances.

Voluntary Correction Program:
Correction is the same as described above under SCP. Employer A makes a VCP submission according to Revenue Procedure 2013-12. The fee for the VCP submission is $2,500. When

making the VCP submission, A should include Forms 8950 and 8951 and consider using the model documents in Appendix C of Revenue Procedure 2013-12.

Audit Closing Agreement Program:
Under Audit CAP, correction is the same as described above under SCP. Employer A and the IRS enter into a closing agreement outlining the corrective action and negotiate a sanction based on the maximum payment amount.

How to avoid the mistake:

- Be sure to apply the provisions of the plan correctly when making a determination of what contributions or benefits are provided to participants. Develop a way to communicate changes timely and accurately to plan administrators and outside service providers (outside plan consultant, actuary and/or third party administrator/record keeper)
- Have a clear process for making distributions. This process should include the plan procedures for ensuring appropriate authorization, accuracy and timeliness. Identify a team responsible to oversee payments.
- Establish protocols and an action plan to use when errors are identified including the appropriate actions to resolve the errors.
- Identify the plan trustees as well as the procedures for tracing cash contributions and receipts by the trust custodian.
- Clearly identify the custodian of trust assets including procedures for maintaining trust asset data, communication mechanisms for transferring trust asset data to the trustee, and the reconciliation process including how to deal with errors.

Return to Table

Mistake	Find the Mistake	Fix the Mistake	Avoid the Mistake
You didn't use the plan definition of compensation correctly for all deferrals and allocations.	Review the plan document definition of compensation used for determining elective deferrals, employer nonelective and matching contributions, maximum annual additions and top-heavy minimum contributions. Review the plan election forms to determine if they're consistent with plan terms.	Corrective contribution or distribution.	Perform annual reviews of compensation definitions and ensure that the person in charge of determining compensation is properly trained to understand the plan document.

3) You didn't use the plan definition of compensation correctly for all deferrals and allocations.

Because your plan may use different definitions of compensation for different purposes, it's important to apply the proper definition for deferrals, allocations and testing. A plan's compensation definition must satisfy rules for determining the amount of contributions. One of those rules is that the amount of compensation considered under the plan can't exceed $260,000 in 2014 (subject to cost-of-living adjustments for later years). This limit is described in IRC Section 401(a)(17).

You must follow the plan document compensation definitions. Compensation generally includes the pay a participant received from the employer for personal services for a year including:

- Wages and salaries
- Fees for professional services
- Other amounts received (cash or non-cash) for personal services actually rendered, including, but not limited to:
    - Commissions and tips
    - Fringe benefits
    - Bonuses

Your plan may contain different compensation definitions for different purposes. In some cases, you or the plan administrator may use an incorrect definition in determining the compensation eligible to be deferred, computing the matching contribution or in calculating the ADP or ACP test. Also, you may fail to limit compensation as required by IRC Section 401(a)(17).

How to find the mistake:

Review the plan document to determine if you're using the proper compensation for allocations, deferrals and testing. Many plan sponsors operate their plan based on a plan summary of the definitions and operational requirements. As the plan is amended, the compensation definition may change while the plan continues to operate as it had previously.

Review the plan sections dealing with allocations and deferrals. Each plan contains sections, either in the plan document or in an adoption agreement, that discuss how the plan must make allocations and deferrals. This section may say, for example, "Employees may defer up to 15% of their Compensation…" You then have to go to the plan section containing definitions and find the "Compensation" definition. Spot-check deferrals and allocations to see if you're using the correct compensation. Some of these definitions can get complicated with expense reimbursements, car allowances, bonuses, commissions and overtime pay that is or is not included in the definition of compensation. If you have a plan with a complicated definition of compensation, you may want to develop a worksheet to calculate the correct amounts.

How to fix the mistake:

Corrective action:
There are a couple of ways to make corrections when you have improperly allocated amounts because you didn't follow the plan definition of compensation. If you've improperly determined elective deferrals, give the participant a distribution of the excess amount plus earnings. If there are improper profit-sharing allocations, forfeit and reallocate the allocations plus earnings to plan participants or put them in an unallocated account for later use. Of course, an improper allocation may also result in an under contribution. If this happens, make a corrective contribution, including earnings, for the affected participants.

Example:
Employer Z sponsors a 401(k) plan with six participants. The plan definition of compensation for deferrals and allocations was amended, effective 2005, to exclude bonuses. For the 2012-plan year, Employer Z improperly included bonuses in compensation when determining allocations and deferrals. Three highly compensated employees each had base compensation of $120,000 and a $30,000 bonus. Each of these highly compensated employees had deferral percentages of 6% of compensation and the plan provides for a fixed profit-sharing allocation of 5% of compensation to each participant's account.

- Each of the three employees properly received a profit-sharing allocation equal to 5% of their $120,000 compensation ($6,000), but improperly received an allocation equal to 5% of the $30,000 bonus ($1,500).
- Each of the three employees properly deferred 6% of their $120,000 base compensation ($7,200), but improperly deferred 6% of the $30,000 bonus ($1,800).

For each employee, Employer Z should forfeit the profit-sharing allocations of $1,500 plus earnings and put the funds in an unallocated account to use for profit-sharing allocations in future years and distribute the improperly allocated elective deferrals of $1,800 plus earnings to each of the three employees.

Correction programs available:

Self-Correction Program:
The example illustrates an operational problem because Employer Z didn't follow the plan terms by including bonuses in compensation when determining plan allocations. If the other eligibility requirements are satisfied, Employer Z may use SCP to correct the mistake.

- No fees for self-correction.
- Practices and procedures must be in place.
- If the mistakes are **significant** in the aggregate:
  - Employer Z needs to complete correction by December 31, 2014.
  - If not corrected by December 31, 2014, Employer Z isn't eligible for SCP and must correct under VCP.
- If the mistakes are **insignificant** in the aggregate, Employer Z can correct beyond the two-year correction period for significant errors. Whether a mistake is insignificant depends on all facts and circumstances.

Voluntary Correction Program:
Correction is the same as described under SCP. Employer Z makes a VCP submission. Employer Z's plan had six participants, so the fee for the VCP submission is $750. When making the submission, Z should include Forms 8950 and 8951 and consider using the model documents in Revenue Procedure 2013-12 Appendix C.

Audit Closing Agreement Program:
Under Audit CAP, correction is the same as under SCP. Employer Z and the IRS enter into a closing agreement outlining the corrective action and negotiate a sanction based on the maximum payment amount.

How to avoid the mistake:

- Perform annual reviews of the plan operations.
- If the plan document is amended, check the definitions against the old document, noting any differences. Have a centralized person or department responsible for maintaining all plan documents.
- If you amend your plan document, communicate those changes to everyone involved in the plan's operation. Plan sponsors should develop an internal communication mechanism to timely and accurately advise plan administrators and outside service providers (outside plan consultant, actuary and/or third party administrator/record keeper) of changes.
- Provide proper training of in-house personnel who determine compensation to understand the plan document.
- Know what your third party administrators have agreed to provide. They may be relying on you for information, such as compensation and deferral amounts used in their work. Retain a copy of your third party administrator service contract including any updated contracts; and keep a summary of what's being supplied to the plan by the third party administrator, actuary or consultant. Keep this service contract and summary with the person responsible for maintaining all plan documents.
- Try to simplify your plan's definition of compensation and use the same definition for multiple purposes.

Return to Table

Mistake	Find the Mistake	Fix the Mistake	Avoid the Mistake
Employer matching contributions weren't made to all appropriate employees.	Review the plan document to determine the employee eligibility requirements and matching contribution formula and compare it to what's used in operation.	Apply reasonable correction method that would put affected participants in the same position they would've been in if there were no operational plan defects.	Contact plan administrators to ensure that they have adequate employment and payroll records to make calculations.

4) Employer matching contributions weren't made to all appropriate employees.

Employers sometimes fail to contribute the employer matching contribution according to the plan document. In many cases, the problem is caused by failing to properly count hours of service or identify plan entry dates for employees. You also may make incorrect contributions when you or the plan service providers fail to follow the plan document terms. Another common problem is using the incorrect definition of compensation from the plan document for determining matching contributions. For example, you or your administrator may not include deferrals in compensation when calculating the matching contribution, but this may be required under the plan document.

Another problem involves the timing of matching contributions. The plan's terms usually state that employer matching contributions will be a percentage of participant deferrals, up to a specific level. Plans generally describe these matching contributions in terms of annual amounts and percentages. If your plan administrator calculates the matching contribution on a payroll period basis, rather than on an annual basis, at the end of the year, the sum of these amounts may not comply with the terms of the plan.

How to find the mistake:

To avoid mistakes in this area:

- Review the plan document to determine the correct matching contribution formula and compare it to what you used in operation.
- Review the definition of compensation used to calculate matching contributions.
    - Incorrect compensation used to determine elective deferrals normally leads to mistakes in the match.
- Review the timing of the matching contribution in comparison to the plan document requirements.
    - If the plan document states the match is a percentage of the deferrals made on a yearly basis and you make matches on a weekly basis, you may have a mistake.
- Be aware of any changes to your plan document.

How to fix the mistake:

Corrective action:
You should base correction of an incorrect employer matching contribution on the plan's terms and other applicable information at the time of the mistake.

Example:
Employer D sponsors a calendar-year 401(k) plan with 20 participants. The plan document provides that D will make matching contributions equal to 50% of the amount deferred by the

participant for the year up to 6% of compensation. A participant deferring 6% of compensation should have a matching contribution of 3% of compensation.

During the 2012-plan year, D erroneously computed its match based on 50% of the amount deferred by Carla for the year up to 3% of compensation instead of 6% of compensation. Carla received $50,000 in compensation and elected an 8% deferral rate ($50,000 x 8% = $4,000 elective deferrals). Employer D provided a matching contribution to Carla totaling $750 ($50,000 x 3% x 50%). Under the plan terms, Carla was entitled to a $1,500 match ($50,000 x 6% x 50%). As a result, Employer D needs to make a corrective contribution of $750 plus earnings for Carla.

Correction programs available:

Self-Correction Program:
The example illustrates an operational problem because the employer didn't follow the plan terms and improperly applied the plan's matching contribution formula. If the other eligibility requirements of SCP are satisfied, Employer D may use SCP to correct the failure.

- No fees for self-correction.
- Practices and procedures must be in place.
- If the mistakes are **significant** in the aggregate:
    - Employer D needs to make a corrective contribution by December 31, 2014.
    - If not corrected by December 31, 2014, Employer D isn't eligible for SCP and must correct under VCP.
- If the mistakes are **insignificant** in the aggregate, Employer D can correct beyond the two-year correction period for significant errors. Whether a mistake is insignificant depends on all facts and circumstances.

Voluntary Correction Program:
Correction is the same as under SCP. Employer D makes a VCP submission according to Revenue Procedure 2013-12. The fee for the VCP submission is $750. When making its VCP submission, D must include Forms 8950 and 8951 and consider using the model documents in Revenue Procedure 2013-12 Appendix C.

Audit Closing Agreement Program:
Under Audit CAP, correction is the same as under SCP. Employer D and the IRS enter into a closing agreement outlining the corrective action and negotiate a sanction based on the maximum payment amount.

How to avoid the mistake:

- Be familiar with your plan document's terms and implement procedures to ensure that your plan operates according to your plan document.
- Work with your plan administrators to ensure that they have sufficient employment and payroll information to calculate the employer matching contribution per the plan document's terms.
- Identify payroll services performed in-house, or outside services used, and how payroll is communicated to other in-house staff or outside providers servicing the plan. Identify who's in charge and his or her responsibilities.
- Know how deferrals, loans, QDROs or other deduction payments are remitted.
- Be familiar with the procedures for how payroll errors are corrected, how corrections are communicated to the plan administrator and how records of corrections are maintained.

Return to Table

Mistake	Find the Mistake	Fix the Mistake	Avoid the Mistake
The plan failed the 401(k) ADP and ACP nondiscrimination tests.	Conduct an independent review to determine if highly and nonhighly compensated employees are properly classified.	Make qualified nonelective contributions for the nonhighly compensated employees.	Consider a safe harbor plan design or using automatic enrollment. Communicate with plan administrators to ensure proper employee classification and compliance with the plan terms.

5) The plan failed the 401(k) ADP and ACP nondiscrimination tests.

Plan sponsors must test traditional 401(k) plans each year to ensure that the contributions made by and for rank-and-file employees (nonhighly compensated employees) are proportional to contributions made for owners and managers (highly compensated employees). As the NHCEs save more for retirement, the rules allow HCEs to defer more. These nondiscrimination tests for 401(k) plans are called the Actual Deferral Percentage and Actual Contribution Percentage tests.

The ADP test counts elective deferrals (both pre-tax and Roth deferrals, but not catch-up contributions) of the HCEs and NHCEs. Dividing a participant's elective deferrals by the participant's compensation gives you that participant's Actual Deferral Ratio. The average ADR for all NHCEs (even those who chose not to defer) is the ADP for the NHCE group. Do the same for the HCEs to determine their ADP.

Calculate the ACP the same way, instead dividing each participant's matching and after-tax contributions by the participant's compensation.

The ADP test is met if the ADP for the eligible HCEs doesn't exceed the greater of:

- 125% of the ADP for the group of NHCEs, or
- the lesser of:
    - 200% of the ADP for the group of NHCEs, or
    - the ADP for the NHCEs plus 2%.

The ACP test is met if the ACP for the eligible HCEs doesn't exceed the greater of:

- 125% of the ACP for the group of NHCEs, or
- the lesser of:
    - 200% of the ACP for the group of NHCEs, or
    - the ACP for the NHCEs plus 2%.

You may base the ADP and ACP percentages for NHCEs on either the current or prior year contributions. The election to use current or prior year data is in the plan document. Under limited circumstances, the election may be changed.

An important aspect of performing the ADP and ACP tests is to properly identify the HCEs, who are generally any employee who:

- Was a 5% owner at any time during the current or prior year (a 5% owner is someone who owns more than 5% of the employer), or
- For the prior year, was paid by the employer more than $115,000 (for 2013 and 2014; subject to cost-of-living adjustments in later years) and, if the employer elects, was in the top-paid (top 20%) group of employees.

Family aggregation rules treat a spouse, child, grandparent or parent of someone who's a 5% owner, as a 5% owner. Each of these individuals is an HCE for the plan year.

How to find the mistake:

Complete an independent review to determine if you properly classified HCEs and NHCEs, including all employees eligible to make a deferral, even if they chose not to make one. Plan administrators should pay special attention to:

- Prior year compensation
- The rules related to ownership when identifying 5% owners.
    - Plan administrators need access to ownership documents to identify 5% owners.
    - Take care to identify family members of the owners, as many will have different last names.

Review the rules and definitions in your plan document for:

- Determining HCEs
- Testing compensation
- ADP testing
- ACP testing
- Prior or current year testing

If incorrect data is used for the original testing, then you may have to rerun the tests. If the original or corrected test fails, then corrective action is required to keep the plan qualified.

How to fix the mistake:

Corrective action:
If your plan fails the ADP or ACP test, you must take corrective action described in your plan document during the statutory correction period to cause the tests to pass. The statutory correction period is the 12-month period following the close of the plan year for which the test failed. If you do this, you don't need EPCRS.

If you take corrective action *after* the first 2 ½ months of the correction period, you are also liable for an excise tax (in addition to being required to make the correction).

If correction is not made before the end of the 12-month correction period, the plan may lose its tax-qualified status. You may correct this mistake through EPCRS.

There are two different methods to correct ADP and ACP mistakes beyond the 12-month period. Both require the employer to make a qualified nonelective contribution to the plan for NHCEs. A QNEC is an employer contribution that is always 100% vested and subject to the same distribution restrictions as elective deferrals. Forfeitures can't be used to pay for QNECs.

- Method 1 – Revenue Procedure 2013-12, Appendix A, section .03:
    - Determine the amount necessary to raise the ADP or ACP of the NHCEs to the percentage needed to pass the tests.
    - Make QNECs for the NHCEs to the extent necessary to pass the tests.
        - You must generally make QNECs for all eligible NHCEs.
        - These contributions must be the same percentage for each participant.
- Method 2 – one-to-one correction method under Revenue Procedure 2013-12, Appendix B, section 2.0:
    - Excess contributions (adjusted for earnings) are assigned and distributed to the HCEs.
    - That same dollar amount is contributed as a QNEC to the plan and allocated based on compensation to all eligible NHCEs.
        - Matching contributions (and earnings) related to the excess contributions distributed to the HCEs are forfeited.

Example:
Employer G maintains a 401(k) plan for its employees. During 2014, G performed a review of the plan's operations for the 2012 plan year. During this review, G discovered one participant, identified as an NHCE, was the child of a 5% owner. When the employer reran the ADP test with the corrected classification, HCEs had an ADP of 7% and NHCEs had an ADP of 4%. The maximum passing ADP for the HCE group is 6%, and the plan failed the ADP test. There were no matching or other employee contributions for the 2012 plan year. The plan has 21 participants.

Correction programs available:

Less than two years from end of statutory period

For mistakes corrected within two years after the end of the 12-month correction period:
- SCP may be used to correct both significant and insignificant mistakes
- VCP may also be used to correct this mistake

More than two years from end of statutory period

For mistakes corrected more than two years after the end of the 12-month correction period:
- SCP may still be used to correct as long as the mistake can be classified as insignificant
- VCP may be used to correct both insignificant and significant mistakes

Example: A 401(k) plan fails the ADP test for the plan year ending December 31, 20x1

Plan year tested:	12/31/20x1
Statutory correction period (12 months):	01/01/20x2 to 12/31/20x2
If correction occurs by 03/15/20x2	No further action required
If correction occurs after 03/15/20x2 but before 12/31/20x2	Employer is required to file a Form 5330 and pay a 10% excise tax on the excess
If correction occurs between 01/01/20x3 and 12/31/20x4	May use SCP or VCP to correct mistakes determined to be insignificant or significant
If correction occurs after 12/31/0x4	• May only use SCP to correct mistakes determined to be insignificant • May use VCP to correct both insignificant and significant mistakes

Self-Correction Program:
EPCRS defines this as an operational error. G determined the plan had established practices and procedures designed to keep it compliant and that the mistake wasn't significant. Correction could involve one of two methods:
- G could make QNECs to the NHCEs to raise the ADP to a percentage that would enable the plan to pass the test.
    - In this example, each NHCE would receive a QNEC equal to 1% of the employee's compensation.

    - G must make these contributions for each eligible NHCE (if the contribution doesn't cause the 415 limit to be exceeded).
- Under the second method, the plan could use the one-to-one correction method.
    - Excess contribution amounts are determined.
        - The amount is assigned to HCEs and adjusted for earnings and this total amount is distributed to the HCEs.
    - An amount equal to the distributed amount is contributed to the plan and allocated based on compensation among the eligible NHCEs.

If G determined the mistake to be significant, it must make the correction by the end of the correction period. The correction period for an ADP/ACP testing failure ends on the last day of the second plan year following the plan year that includes the last day that G could have normally corrected the ADP/ACP mistake. The mistake occurred in 2012, with the normal correction period ending in 2013, so the correction period under SCP for significant mistakes ends on the last day of the 2015 plan year.

Voluntary Correction Program:
If G determined the mistake wasn't correctible under SCP, or if it elected to correct the mistake under VCP, correction would be the same as under SCP. G would need to file a VCP submission. Based on the number of participants in our example, 21, G would pay a fee of $1,000. When making its VCP submission, G must include Forms 8950 and 8951 and consider using the model documents in Revenue Procedure 2013-12 Appendix C.

Audit Closing Agreement Program:
Most plans are eligible for Audit CAP, which allows the plan sponsor to correct the mistake and pay a negotiated sanction. This sanction would bear a reasonable relationship to the nature, extent and severity of the mistake, considering many factors, including the extent to which correction occurred before audit. Sanctions under Audit CAP are a negotiated percentage of the maximum payment amount.

How to avoid the mistake:

One way to avoid this type of mistake is by establishing a safe harbor 401(k) plan or by changing an existing plan from a traditional 401(k) plan to a safe harbor 401(k) plan. Under a safe harbor 401(k) plan, the employer isn't required to perform the ADP and ACP tests, if it meets certain requirements.

Problems may happen when there's a communication gap between the employer and plan administrator regarding what the plan document provides and what documentation is needed to ensure compliance. Several main areas where these communication problems may occur:
- Count all eligible employees in testing:
    - Share information with the plan administrator on all employees eligible to make an elective deferral (including all eligible employees who terminated before the end of the year).
- Share information with the plan administrator about any related companies with common ownership interests.
    - Your plan document may require these employees to be eligible to participate in the plan, and, therefore, included in the tests.
- Definition of compensation:
    - Be familiar with the terms of your plan document to ensure that you use the proper definition of compensation.
    - It's important to know whether compensation is:

    - Excluded for certain purposes,
    - Limited for certain purposes, or
    - Determined using a different computation period (for example, plan year vs. calendar year).
  - If the compensation amounts sent to the plan administrator don't meet the plan definitions, the ADP and ACP tests will be inaccurate and will provide false results.
- Identification of HCEs:
  - An important aspect of performing the ADP and ACP tests is properly identifying HCEs. It's especially important to consider family members of owners.
  - Don't assume that once a nonhighly compensated employee, always a nonhighly compensated employee.

In summary, you should ensure that you're familiar with your plan's terms, and provide your plan administrator with the information needed to make a proper determination of each employee's status.

If either the ADP or the ACP test fails, to avoid correcting under EPCRS, implement procedures to ensure that you correct excess contributions timely. Excess contributions result from plans failing to satisfy the ADP test and should be distributed to the applicable HCEs within 12 months following the close of the plan year. Excess aggregate contributions are contributions resulting from a plan that has failed the ACP test. The law generally treats them the same as excess contributions. However, if the excess aggregate contributions consist of matching contributions that aren't fully vested then reallocate the unvested portion to the accounts of the other plan participants or put these in an unallocated suspense account to use to reduce future contributions.

Return to Table

Mistake	Find the Mistake	Fix the Mistake	Avoid the Mistake
Eligible employees weren't given the opportunity to make an elective deferral election (excluding eligible employees).	Review the plan document sections on eligibility and participation. Check with plan administrators to determine when employees are entering the plan.	Make a qualified nonelective contribution for the employee that compensates for the missed deferral opportunity.	Monitor census information and apply participation requirements.

6) Eligible employees weren't given the opportunity to make an elective deferral election (excluding eligible employees).

Your 401(k) plan document should contain a definition of "employee" and provide requirements for when employees must become plan participants eligible to make elective deferrals. Employers sometimes assume the plan doesn't cover certain employees, such as part-time employees. Similarly, employees who elect not to make elective deferrals are often mistakenly treated as ineligible employees under the plan when other plan contributions are made and tests run. To reduce the risk of omitting eligible employees, you should ensure the accuracy of employee data such as dates of birth, hire and termination; number of hours worked; compensation for the year; 401(k) election information and any other information necessary to properly administer the plan.

Generally, treat each employee who receives a Form W-2 as an eligible employee unless you can properly exclude that employee by the plan terms. Using the plan definition of eligible employee with the plan age and service requirements, determine each employee's eligibility. If you use leased employees, contract labor or have shared ownership of other enterprises, determining eligible employees can be complicated.

A retirement plan doesn't qualify for tax-preferential treatment unless it meets the eligibility and participation standards. These general rules are:

- A plan may not require an employee to be older than 21 to participate, and
- Two ways to credit service to an employee:
    - **Hours of service**: A 401(k) plan may not require more than a year of service as a condition of being eligible to participate.
        - A year of service means a calendar year, plan year or any other consecutive 12-month period during which the employee completes at least 1,000 hours of service starting on the employment commencement date.
    - **Elapsed time**: Under the elapsed time method, an employee's eligibility to participate isn't based on the completion of a specified number of hours of service, but it's generally determined in reference to a 12-month period.
- An eligible employee must enter the plan within 6 months after satisfying the eligibility requirements under the plan.
- The plan document may be more liberal by allowing a younger age and lesser service requirement. For example, a plan may allow a person to participate immediately when hired.
- Your plan document contains the definitions and requirements for becoming a plan participant.

In addition, you must give eligible employees the opportunity to make a salary deferral election and should retain copies of who is notified of this opportunity and when.

How to find the mistake:

Review your plan document concerning eligibility and participation. Check when employees are entering the plan.

- Make a list of all employees who received a W-2.
- Compare each employee's date of hire, birth, termination and number of hours worked against the eligibility and participation requirements of the plan document.
- Determine the date that each employee is entitled to become a plan participant (plan entry date) according to the plan document.
- Inspect payroll and plan records to ensure that the employees timely entered the plan and that you gave them the opportunity to make a deferral election.

How to fix the mistake:

Corrective action:
Generally, if you didn't give an employee the opportunity to make elective deferrals to a 401(k) plan, you must make a qualified nonelective contribution to the plan for the employee. This contribution must compensate for the missed deferral opportunity. The corrective QNEC is an employer contribution that's intended to replace the lost opportunity to a participant who wasn't permitted to make elective deferrals. The QNEC must be 100% vested and subject to the same distribution restrictions as elective deferrals. Forfeitures can't be used for QNECs.

The amount of the QNEC is equal to **50%** of the employee's missed deferral determined by multiplying the actual deferral percentage for the employee's group (HCE or NHCE) in the plan for the year of exclusion by the employee's compensation for that year.

Example:
Employer D sponsors a 401(k) plan with eight participants. The plan uses a calendar plan year. The plan has a one-year-of-service-eligibility requirement and provides for January 1 and July 1 entry dates. Jack, whom Employer D should've allowed to make elective deferrals on January 1, 2012, wasn't given that opportunity until January 1, 2013. Jack was a NHCE with compensation for 2012 of $80,000. The ADP for 2012 was 10% for HCEs and 8% for NHCEs. Employer D found this mistake during a plan review in 2013.

Employer D must make a corrective contribution for the 2012 missed deferral opportunity. Jack's missed deferral is equal to the 8% ADP for NHCEs multiplied by $80,000 (compensation earned for the portion of the year in which D erroneously excluded Jack, January 1 through December 31, 2012). The missed deferral amount, based on this calculation is $6,400 ($80,000 x 8%). The missed deferral opportunity is $3,200 (50% multiplied by the missed deferral of $6,400). Employer D must make a corrective contribution of $3,200, adjusted for earnings through the date of correction, for Jack.

Correction programs available:

Self-Correction Program:
The example shows an operational problem because Employer D failed to follow the plan terms by not giving Jack the opportunity to participant in the plan for the 2012-plan year. If the other eligibility requirements of SCP are satisfied, Employer D may use SCP to correct the failure.

- No fees for self-correction.
- Practices and procedures must be in place.
- If the mistakes are **significant** in the aggregate:
    - Employer D needs to make a corrective contribution by December 31, 2014.

- If not corrected by December 31, 2014, Employer D isn't eligible for SCP and must correct under VCP.

- If the mistakes are **insignificant** in the aggregate, Employer D can correct beyond the two-year correction period for significant errors. Whether a mistake is insignificant depends on all facts and circumstances.

Voluntary Correction Program:
Correction is the same as under "Corrective action." Employer D makes a VCP submission according to Revenue Procedure 2013-12. The fee for the VCP submission is $750. When making a VCP submission, D should include Forms 8950 and 8951 and consider using the model documents in Revenue Procedure 2013-12 Appendix C.

Audit Closing Agreement Program:
Under Audit CAP, correction is the same as under "Corrective action." Employer D and the IRS enter into a closing agreement outlining the corrective action and negotiate a sanction based on the maximum payment amount.

How to avoid the mistake:

- Review your plan document for the definition of "employee" and provisions of employee eligibility.
- Provide proper training about the plan document to in-house personnel who determine employee eligibility .
- Look at your payroll records for the total number of employees, birth dates, hire dates, hours worked, and other pertinent information. Also inspect Form(s) W-2 and state unemployment tax returns and compare employee data on these records with the payroll records to see if employee counts are accurate.
- Establish protocols and a corrective action plan that will be triggered when errors are identified.

Return to Table

Mistake	Find the Mistake	Fix the Mistake	Avoid the Mistake
Elective deferrals weren't limited to the amounts under IRC Section 402(g) for the calendar year and excess deferrals weren't distributed.	Inspect deferral amounts for plan participants to ensure that the employee hasn't exceeded the limits.	Distribute excess deferrals.	Work with plan administrators to ensure that they have sufficient payroll information to verify the deferral limitations of IRC Section 402(g) were satisfied.

7) Elective deferrals weren't limited to the amounts under IRC Section 402(g) for the calendar year and excess deferrals weren't distributed.

Internal Revenue Code Section 402(g) limits the amount of elective deferrals a plan participant may exclude from taxable income each calendar year. IRC Section 401(a)(30) provides that, for a plan to be qualified, it must provide that the amount of elective deferrals for each participant under all plans of the same employer not exceed the 402(g) limits. The limit on elective deferrals under Section 402(g) is:

- $17,500 in 2014
- This limit is subject to cost-of-living increases for later years (for prior years, refer to the cost-of–living adjustment table)

Limits on the amount of elective deferrals a plan participant may contribute to a SIMPLE 401(k) plan are different than those in a traditional or safe harbor 401(k) plan.

- SIMPLE 401(k) deferrals are limited to $12,000 in 2014.
- This limit is subject to cost-of-living increases in later years.

Catch-up contributions: A plan may permit participants age 50 or over at the end of the calendar year to make additional deferrals. These additional contributions are called catch-up contributions, and these aren't subject to the general limits that apply to 401(k) plans (see IRC Section 414(v)). An employer isn't required to provide for catch-up contributions. However, if your plan allows catch-up contributions, you must allow **all** eligible participants to make catch-up contributions.

- If an employee participates in a traditional or safe harbor 401(k) plan and is age 50 or older, the elective deferral limit increases by $5,500 in 2014.
- If an employee participates in a SIMPLE 401(k) plan and is age 50 or older, the elective deferral limit increases by $2,500 in 2014.
- These limits are subject to cost-of-living increases in later years.
- The catch-up contribution for a year can't exceed the lesser of:
  - The catch-up contribution limit, or
  - The excess of the employee's compensation over the elective deferrals that aren't catch-up contributions.

Catch-up contributions are **not** subject to the Section 401(a)(30) plan qualification rule.

Elective deferrals include both pre-tax deferrals and designated Roth contributions. Generally, you must consider all elective deferrals made by a participant to all plans in which the employee participates to determine if the employee has exceeded the 402(g) limits. If an employee has elective deferrals in excess of the 402(g) limit under one or more plans of an employer, each plan is subject to disqualification.

Your plan document may impose its own lower limit on the deferral amount or on the percentage of pay that participants may defer. Additionally, your plan may need to limit a plan participant's elective deferrals to meet certain nondiscrimination requirements.

If the total of a plan participant's elective deferrals exceeds the limit under IRC Section 402(g), to avoid failing IRC Section 401(a)(30), the excess amount plus allocable earnings must be distributed to the participant by April 15 of the year following the year of deferral. Excess deferrals not timely returned to the participant are subject to additional tax.

Timely withdrawal of excess contributions by April 15:

- Excess deferrals withdrawn by April 15 of the year following the year of deferral are taxable in the calendar year deferred.
- Earnings are taxable in the year they're distributed.
- There is no 10% early distribution tax, no 20% withholding and no spousal consent requirement on amounts timely distributed.

Consequences of a late distribution:

- Under IRC Section 401(a)(30), if the excess deferrals aren't withdrawn by April 15, each affected plan of the employer is subject to disqualification and would need to go through EPCRS.
- Under EPCRS, these excess deferrals are still subject to double taxation; that is, they're taxed both in the year contributed to and in the year distributed from the plan.
- These late distributions could also be subject to the 10% early distribution tax, 20% withholding and spousal consent requirements.

Excess deferrals distributed to highly compensated employees are included in the ADP test in the year the amounts were deferred. Excess deferrals distributed to nonhighly compensated employees aren't included in the ADP test if all deferrals were made with one employer. Excess deferrals distributed after April 15 are included in annual additions for the year deferred.

How to find the mistake:

Ensure that no one's deferrals exceed the 402(g) limit for a year by comparing the amount deferred to the 402(g) limit. If anyone exceeds the 402(g) limit and this isn't corrected, the plan could be disqualified.

How to fix the mistake:

IRC Section 72(t) imposes a 10% additional tax for distributions that don't meet an exception, such as death, disability or attainment of age 59 ½, among others. To avoid this additional tax, correct excess deferrals no later than April 15 of the following year. If you don't correct by April 15, you may still correct this mistake under EPCRS; however, it won't relieve any Section 72(t) tax resulting from the mistake.

Under Revenue Procedure 2013-12, Appendix A, section .04, the permitted correction method is to distribute the excess deferral to the employee and to report the amount as taxable **both** in the year of deferral and in the year distributed. These amounts are reported on Forms 1099-R.

Example:

Employer X maintains a 401(k) plan that has 21 participants. For calendar year 2012, Ann deferred $18,000 to the plan. Ann is under age 50 and isn't eligible to make catch-up contributions. Ann has excess deferrals of $1,000 because $17,000 is the 402(g) maximum amount permitted for 2012. Employer X didn't discover this mistake until after April 15, 2013. On

November 1, 2013, X distributed the excess deferral (plus earnings of $100, totaling $1,100) to Ann.

For 2012 (year of deferral), Ann must include **$1,000** in gross income. For 2013 (year of distribution), Ann must include **$1,100** in gross income. Employer X would report this amount on Form 1099-R. In addition, Ann must pay the additional 10% early distribution tax under IRC Section 72(t).

Correction programs available:

Self-Correction Program:
The example shows an operational problem because Employer X failed to follow the plan terms prohibiting any employee's elective deferrals from exceeding the 401(a)(30) limit. If the other eligibility requirements of SCP are satisfied, Employer X may use SCP to correct the failure.

- No fees for self-correction.
- Practices and procedures must be in place.
- If the mistakes are **significant** in the aggregate:
  - Employer X needs to make a corrective distribution by December 31, 2014.
  - If not corrected by December 31, 2014, Employer X isn't eligible for SCP and must correct under VCP.
- If the mistakes are **insignificant** in the aggregate**,** Employer X can correct beyond the two-year correction period for significant errors. Whether a mistake is insignificant depends on all facts and circumstances.

Voluntary Correction Program:
Correction is the same as under SCP. Employer X makes a VCP submission per Revenue Procedure 2013-12. The fee for the VCP submission is $1,000. When making its VCP submission, Employer X must include Forms 8950 and 8951 and should consider using the model documents in Revenue Procedure 2013-12 Appendix C.

Audit Closing Agreement Program:
Under Audit CAP, correction is the same as under SCP. Employer X and the IRS enter into a closing agreement outlining the corrective action and negotiate a sanction based on the maximum payment amount.

How to avoid the mistake:

- Work with your plan administrator to ensure that the administrator has sufficient payroll information to verify that the deferral limitations of IRC Section 402(g) were satisfied.
- Establish procedures to ensure that, based on the participant election forms (including modifications), participants won't exceed the IRC Section 402(g) limit.
- Have checks and balances in place to alert you and your plan administrator when the limit is exceeded to take timely corrective action.

Return to Table

Mistake	Find the Mistake	Fix the Mistake	Avoid the Mistake
You haven't timely deposited employee elective deferrals.	Determine the earliest date you can segregate deferrals from general assets. Compare that date with the actual deposit dates and any plan document requirements.	Usually corrected through DOL's Voluntary Fiduciary Correction Program. You may also need to correct through the IRS correction program. Deposit all elective deferrals withheld and earnings resulting from the late deposit into the plan's trust.	Coordinate with your payroll provider to determine the earliest date you can reasonably segregate the deferral deposits from general assets. Set up procedures to ensure you make deposits by that date.

8) You haven't timely deposited employee elective deferrals.

The employer is responsible for contributing the participants' deferrals to the plan trust. If your plan document contains language about the timing of deferral deposits, you may correct failures to follow the plan document terms under EPCRS. However, this type of mistake can also lead to another problem – a "prohibited transaction," which is a transaction between a plan and a disqualified person that the law prohibits. An employer is a disqualified person.

A disqualified person who participates in a prohibited transaction must correct this and pay an excise tax based on the amount involved in the transaction. The initial tax on a prohibited transaction is 15% of the amount involved for each year. If the disqualified person doesn't correct the transaction, an additional tax of 100% of the amount involved may be due.

Department of Labor rules require that the employer deposit deferrals to the trust as soon as the employer can; however, in no event can the deposit be later than the 15th business day of the following month. Remember that the rules about the 15th business day isn't a safe harbor for depositing deferrals; rather, that these rules set the maximum deadline. DOL provides a 7-business-day safe harbor rule for employee contributions to plans with fewer than 100 participants.

If the employer doesn't make the deposits timely, the failure may constitute both an operational mistake, giving rise to plan disqualification (if the plan specifies a date by which the employer must deposit elective deferrals) and a prohibited transaction. Although an employer can correct an operational mistake under EPCRS, a prohibited transaction can't be corrected under EPCRS. However, the DOL maintains a Voluntary Fiduciary Correction Program (VFCP) that may be used to resolve the prohibited transaction.

For an additional discussion of prohibited transactions, see question 9(b).

Timing of other contributions:
Rules about the timing of matching contributions or other employer contributions are different from those for elective deferrals. The employer must meet the following rules to obtain a current tax deduction:

- Contributions made by the employer to match deferrals may be made at the time of the elective deferral contribution or later, but not later than the filing deadline of the employer's income tax return, including extensions.
- Employer contributions that aren't tied to elective deferrals must be made by the filing deadline of the employer's tax return, including extensions.

Review your plan document for the timing and amount of your matching and other employer contributions.

How to find the mistake:

Review plan terms relating to the deposit of elective deferrals and determine if you've followed them. Although it isn't common, some plan documents contain a specific time for deposits. For example, if the plan document states the deposit will be made on a weekly basis, but deposit(s) are made on a biweekly basis, you may have an operational mistake requiring correction under EPCRS. Your mistake would be not operating the plan according to its document, which can be corrected under EPCRS.

How to fix the mistake:

Corrective action:
Correction through EPCRS may be required if the terms of the plan weren't followed. Correction for late deposits may require you to:

- Determine which deposits were late and calculate the lost earnings necessary to correct.
- Deposit any missed elective deferrals, together with lost earnings, into the trust.
- Review procedures and correct deficiencies that led to the late deposits.

Example:
Employer B sponsors a 401(k) plan for its 1,200 employees, all of whom are plan participants. Employer B pays employees on the first day of the month. The plan **expressly** provides that the employer must deposit deferrals within five days after each payday. B conducts a yearly compliance audit of its plan. During this review, Employer B discovered it deposited elective deferrals 30 days after each payday for the 2012 plan year.

Correction programs available:

Employer B didn't make the deposits within the time required by the plan document. This operational mistake is correctible under EPCRS.

Self-Correction Program:
The example shows an operational problem because the employer didn't follow the plan terms for the timing for depositing elective deferrals. If the other eligibility requirements of SCP are satisfied, Employer B may use SCP to correct the failure.

- No fees for self-correction.
- Practices and procedures must be in place.
- If the mistakes are **significant** in the aggregate:
    - Employer B needs to make a corrective contribution by December 31, 2014.
    - If not corrected by December 31, 2014, Employer B isn't eligible for SCP and must correct under VCP.
- If the mistakes are **insignificant** in the aggregate, Employer B can correct beyond the two-year correction period for significant errors. Whether a mistake is insignificant depends on all facts and circumstances.

Voluntary Correction Program:
Correction is the same as under "Corrective action." Employer B makes a VCP submission per Revenue Procedure 2013-12. Employer B's plan has 1,200 participants, so the fee for the VCP submission is $15,000. When making a VCP submission, B must include Forms 8950 and 8951 and consider using the model documents in Revenue Procedure 2013-12 Appendix C.

Audit Closing Agreement Program:
Under Audit CAP, correction is the same as under "Corrective action." Employer B and the IRS enter into a closing agreement outlining the corrective action and negotiate a sanction based on the maximum payment amount.

How to avoid the mistake:

- Establish a procedure requiring elective deferrals to be deposited coincident with or after each payroll per the plan document. If deferral deposits are a week or two late because of vacations or other disruptions, keep a record of why those deposits were late.
- Coordinate with your payroll provider and others who provide service to your plan, if any, to determine the earliest date you can reasonably make deferral deposits. The date and related deposit procedures should match your plan document provisions, if any, about this issue.
- Implement practices and procedures that you explain to new personnel, as turnover occurs, to ensure they know when deposits must be made.

Return to Table

Mistake	Find the Mistake	Fix the Mistake	Avoid the Mistake
Participant loans don't conform to the requirements of the plan document and IRC Section 72(p).	Review the plan document and all outstanding loans to ensure that the loans comply with the plan terms and that employees are repaying their loans timely.	You may correct some failures by corrective repayment and/or modification of loan terms.	Review and follow the plan provisions for making loans, including the loan amount, loan term and repayment terms. Ensure that there are procedures in place to prevent loans from being prohibited transactions.

9) a) Participant loans don't conform to the requirements of the plan document and IRC Section 72(p).

Many 401(k) plans permit loans to participants. Plan sponsors should ensure that their plan document allows loans before allowing participants to borrow money from the plan. Some plan documents include a complete description of loan rules. Others make only a statement that the plan allows participant loans, subject to a separate written loan program.

A participant loan must meet several rules under IRC Section 72(p) to prevent the law from treating it as a taxable distribution. The rules are:

1) The loan must be a **legally enforceable agreement**.
    a. It can be a paper or electronic document stating the date and amount of the loan and binding the participant to a repayment schedule.
    b. It must be a secured loan and the interest rate and repayment schedule should be similar to what a participant might expect to receive from a financial institution.
2) The **amount of the loan** can't be more than 50% of the participant's vested account balance up to a maximum of $50,000.
    a. An exception allows a participant to borrow a minimum $10,000.
    b. If the participant previously took another loan, then the $50,000 limit is reduced by the highest outstanding loan balance during the one-year period ending on the day before the new loan.
3) The loan **terms** should require the participant to make level amortized payments at least quarterly.
    a. Each payment should include an allocation of principal and interest.
    b. The loan must be repaid within five years, unless the participant uses the loan to purchase his or her main home.
4) Exception for leave of absence:
    a. May suspend repayments for up to one year while the participant is on a leave of absence
    b. May not extend the loan's maximum repayment period.
    c. On return from leave of absence, the participant must make additional payments to ensure repayment within the five-year-period by either:
        i. increasing the payments over the rest of the loan, or
        ii. keeping the payments the same, but making a catch up payment for the missed payments during the leave of absence.

    Note: A plan may suspend loan payments for more than one year for an employee performing military service. In this case, the employee must repay the loan within five years from the date of the loan, plus the period of military service.

How to find the mistake:

Review the loan agreements and loan repayments to verify they've met the rules to prevent the loans from being treated as taxable distributions. This review should include:

- Determining whether there are written loan agreements for outstanding loans. If not, the loan is a taxable distribution to the participant.
- Reviewing the terms of each loan agreement to ensure that it meets the rules required to prevent the loan from being treated as a taxable distribution, including:
    - Are loans due within 5 years?
        - For a loan over 5 years, is there documentation in the file showing the employee used the loan to purchase a main home?
    - Is the interest rate reasonable? The interest rate charged for a loan can't be more favorable than what the participant can get from a financial institution for a similarly secured loan.
    - Was the loan amount less than the dollar limit? You'll need to know the participant's vested account balance as of the loan date, and whether the participant had any loans prior to the date of the loan under review.
    - Does the repayment schedule require the participant to make level repayments at least quarterly? Are the payment amounts properly calculated?
- Ensuring that loan payments are timely made per the loan terms .
    - Many participants repay their loans through payroll withholding. Evaluate the payroll system to ensure that the withheld amounts are properly determined and deposited to the plan timely. Pay particular attention to this issue if there has been a change in payroll systems or providers.

How to fix the mistake:

Corrective action:
It's important that plans have a system in place to ensure that the terms of a participant loan and its repayments follow the law so the loan isn't treated as a taxable distribution. Generally, once a loan violates a rule, the participant can't correct it to save that exemption. The plan administrator can make correction and preserve the exemption in a few circumstances:

- The plan administrator may allow for a "cure period" that would allow a participant to make up for a missed payment. The cure period can't go beyond the end of the second quarter following the quarter in which the missed payment was due.
- If the loan violated the plan document terms or IRC Section 72(p), the plan sponsor has two choices. It may be able to:
    - use the Voluntary Correction Program to permit employees to include the loan amount in income in the year of correction (as opposed to the year in which the problem occurred), or
    - request relief from reporting the loans as taxable distributions to participants from the IRS under the VCP.

  Generally, for a plan loan to be eligible for relief from income tax reporting under VCP:
    - employer action caused the participant's failure to repay the loan, and
    - correction should be done within the maximum time for the loan, usually 5 years.
- The general requirements for correction are:
    - **Loan that exceeds the dollar limit:** The participant must repay the excess loan amount and, if needed, amortize the remaining principal balance as of the repayment date over the original loan's remaining period. The corrective payment for the excess loan amount depends on the:

  - excess amount as of the date of the loan,
  - payments previously made on the loan, and
  - portion of the previously made payments that were allocated to the excess loan amount.

  Three alternative methods that you may use to determine the allocation of prior repayments toward the excess loan amount and the corrective payment required to repay the excess loan amount are:

  (1) Prior repayments are applied to reduce the portion of the loan that didn't exceed the limit. None of the prior payments are allocated to the excess loan amount. The corrective payment for the excess loan amount is equal to the original loan excess, plus interest.
  (2) Prior repayments are used to pay the interest on the excess portion of the loan, with the remainder of the repayments used to reduce the portion of the loan that didn't exceed the limit. The corrective payment for the excess loan amount is equal to the original excess loan amount.
  (3) Prior repayments are applied against the loan excess and the maximum loan amount permitted on a pro-rata basis. The corrective payment for the excess loan amount is equal to the outstanding loan balance attributable to the excess loan amount, after the allocation of prior repayments.

- **Loan that exceeds the maximum loan period:** The outstanding amount of the loan is reamortized over the maximum remaining period allowed under IRC Section 72(p) (5 years) from the original loan date.
- **Loan that's in default (after the passage of the "cure period") because of the failure to make timely payments:** The participant must either:
  - make a lump sum payment for the missed installments (adjusted for interest);
  - reamortize the outstanding loan balance, resulting in higher payments going forward; or
  - a combination of a make-up payment and reamortization of the loan.

Example:
AZCorp 401(k) Plan maintains a participant loan program. The plan has 50 participants, three of whom had participant loans. AZCorp conducted a year-end review of its loan program and found these issues:

- Bob received a plan loan on May 1, 2012. The loan was for $60,000 over a five-year term, amortized monthly using a reasonable interest rate. Bob timely made the required payments. The loan amount is less than 50% of Bob's vested account balance. However, the loan amount exceeds the maximum limit of $50,000.
- Terri received a loan of $10,000, dated April 1, 2012, over a six-year period. Payments are timely and the interest rate is reasonable. The loan term exceeds the maximum 5-year repayment period.
- Dean borrowed $10,000, dated March 1, 2012, over a five-year period. Because of a payroll error, AZCorp failed to withhold the required loan repayments from Dean's pay since August 1, 2012. The loan amount is less than 50% of Dean's vested account balance and the interest rate is reasonable.
- AZCorp corrected the loan errors on February 1, 2013.

Corrective action:
Bob – Loan amount in excess of the $50,000 limit - AZCorp corrected this mistake by requiring a corrective repayment to the plan because of the $10,000 loan excess, according to Method 3, above. Since Bob has already repaid some of the loan, these repaid amounts may be considered in determining the amount of the required corrective repayment. AZCorp applied Bob's prior repayments on a pro-rata basis between the $10,000 loan excess and the $50,000 maximum loan amount. Therefore, Bob's corrective repayment equaled the balance remaining on the $10,000 loan excess as of February 1, 2013, the date of correction.

Terri – Loan term in excess of the 5-year limit - AZCorp is correcting this mistake by reamortizing the loan balance over the maximum remaining period (5 years) from the original loan date. On February 1, 2013, AZCorp reamortized the loan balance for Terri so that it will be fully repaid by April 1, 2017 (5 years from the date of the original loan).

Dean – Loan payments not made - The loan went into default as of November 2, 2012, on the expiration of the plan's stated three-month cure period. AZCorp determined it was partially at fault because it failed to collect loan repayments. AZCorp corrected the mistake by requiring Dean to make a lump sum repayment equal to the additional interest accrued on the loan and reamortize the outstanding balance over the remaining loan period.

Correction programs available:

Self-Correction Program:
This type of mistake can't be corrected under SCP. AZCorp must correct under VCP.

Voluntary Correction Program:
AZCorp makes a VCP submission per Revenue Procedure 2013-12. The fee for the VCP submission is generally based on the number of plan participants. However, the revenue procedure provides for a 50% fee reduction when the loan failure is the only failure of the submission and no more than one quarter of the participants are affected by participant loan errors. In this case, because no more than one quarter of AZCorp's 50 employees were affected by the mistake, the VCP fee is $500 ($1,000 x 50%). When AZCorp makes its VCP submission, it must include Forms 8950 and 8951 and may use the model documents in Revenue Procedure 2013-12 Appendix C.

Audit Closing Agreement Program:
Under Audit CAP, correction is the same as under "Corrective action." AZCorp and the IRS enter into a closing agreement outlining the corrective action and negotiate a sanction based on the maximum payment amount.

How to avoid the mistake:

Develop loan procedures, including:

- A system for determining the participant's maximum loan amount during the loan approval process. The participant's account balance and prior loan history should be available to ensure that the loan is within the limits.
- A written policy for determining the loan terms (for example, the criteria used to determine the loan's interest rate).
- Written, enforceable loan agreements. The plan shouldn't permit loans on an oral or informal basis.
- Loan procedures should provide for a cure period (see "How to fix the mistake"), which allows the plan administrator a window of time to get a payment from the participant without this being considered a missed payment.

- Documentation for exceptions to general rules. For example, if the plan approves loans for over 5 years, the loan request should include evidence that the participant is using the loan to purchase his or her primary residence. These requirements should be part of the plan's loan policy included in the form that a participant completes to request a loan.
- Procedures for monitoring timely repayment. Many plans require loan repayment by payroll deduction. For the process to work, the payroll service provider must know to withhold the loan repayments and needs enough information to determine the correct withholding amount. In addition, the payroll system needs to be able to timely deposit the amounts withheld to the plan.
- Procedures for analyzing deposits. Procedures for the plan's record keeper to allocate the appropriate amounts to the participants' loan balances.
- Accurate software (or other tools) used to determine loan limits and repayment amounts.

9b) Plan loans were made to individuals who are disqualified persons and the loans are prohibited transactions under IRC Section 4975.

Prohibited transactions under IRC Section 4975 are generally any transfer to, or use by, or for the benefit of, a disqualified person of a plan's income or assets. A loan from the plan to a disqualified person may be a prohibited transaction unless it meets specific requirements.

Disqualified persons include, among others, a 50% owner (and family members), fiduciaries and persons who provide service to the plan. For a complete list of disqualified persons, see Publication 560, *Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans)*. Prohibited transactions are subject to an excise tax under IRC Section 4975.

Loans to disqualified persons must meet certain requirements to avoid being a prohibited transaction. The loan must:

- be made available to all participants or beneficiaries,
- be made available to highly compensated employees in an amount equal to the amount made available to other employees,
- be made per specific provisions stated in the plan,
- bear a reasonable rate of interest, and
- be adequately secured.

Loans that are prohibited transactions are generally subject to a 15% excise tax on the amount involved. The "amount involved" generally refers to fair market interest for the disqualified person's use of the plan's money. The disqualified person pays the tax.

How to find the mistake:

To determine if participant loans are prohibited transactions, review the loan agreements and repayments:

1) Determine whether the plan document allows for participant loans and whether the plan and any accompanying loan policy require that loans be made to all participants. (Note: if the plan doesn't allow for participant loans, then any loan made to a disqualified person is a prohibited transaction.)
2) Identify participants who are disqualified persons and determine whether they received plan loans. (Loans made to individuals who aren't disqualified persons aren't prohibited transactions.)
3) Verify that the plan used the same criteria for approving loans to disqualified persons and to other participants.

4) Evaluate the loan terms made to a disqualified person to determine whether the loan was:
   a. based on a reasonable interest rate (for example, a rate similar to what the participant would expect to obtain had a similar loan been taken from a financial institution); and
   b. adequately secured. (If the participant used his or her account balance to secure the loan, the account balance should be greater than the loan amount.)

   Loans made to disqualified persons at below-market interest rates or that aren't adequately secured are prohibited transactions.
5) Review the disqualified person's actual loan payments to determine whether he or she is following the loan document terms. The law treats amounts not timely paid per the loan terms as unsecured loans and prohibited transactions.

How to fix the mistake:

Corrective action:
If a loan is a prohibited transaction, then the disqualified person must repay all outstanding loan amounts (principal and interest) to the plan. Excise taxes under IRC Section 4975 apply until the loan is fully repaid. The disqualified person pays the excise taxes on Form 5330, *Return of Excise Taxes Related to Employee Benefit Plans*.

Correction programs available:

The IRS doesn't have a correction program that provides relief from the excise taxes owed under IRC Section 4975. The disqualified person must pay all excise taxes owed on the prohibited transaction.

How to avoid the mistake:

- Before making a loan to a participant (including a disqualified person), ensure that the plan document provides for loans and that the loan complies with the plan terms.
- The plan should establish a loan policy consistent with the plan terms that ensures that the terms of any loan issued to a disqualified person satisfies the conditions for it not to be a prohibited transaction.
- The plan administrator should monitor payments made by the disqualified person to ensure that he or she makes the payments per the loan terms.

Some loan transactions may also result in fiduciary violations under Title I of the Employee Retirement Income Security Act. The Department of Labor has established the Voluntary Fiduciary Correction Program to enable correction of some fiduciary violations.

Return to Table

Mistake	Find the Mistake	Fix the Mistake	Avoid the Mistake
Hardship distributions weren't made properly.	Review all in-service distributions and determine whether hardship distributions met the plan requirements.	Amend plan retroactively to allow for hardship distributions. If impermissible hardship distribution, have participant return hardship distribution amount plus earnings.	Be familiar with your plan document's hardship provisions and ensure that you follow the provisions in operation. Ensure that your plan administrators and payroll offices share the plan's hardship distribution information.

10) Hardship distributions weren't made properly.

A 401(k) plan may allow employees to receive a hardship distribution because of an immediate and heavy financial need. Hardship distributions from a 401(k) plan are limited to the amount of the employee's elective deferrals and generally don't include any income earned on the deferred amounts. The employee can't roll over hardship distributions to another plan or IRA. The law treats a distribution as a hardship distribution only if it's made both because of an employee's immediate and heavy financial need and is necessary to satisfy that financial need**.** The employer determines whether an employee has an immediate and heavy financial need based on all relevant facts and circumstances; however, the law deems a distribution to be made because of an employee's **immediate and heavy financial need** if the distribution is for:

- Medical care expenses previously incurred by the employee, the employee's spouse or any dependents of the employee, or if necessary for these persons to obtain medical care;
- Costs directly related to the purchase of a principal residence for the employee (excluding mortgage payments);
- Payment of tuition, related educational fees, and room and board expenses for the next 12 months of post-secondary education for the employee, the employee's spouse, children or dependents;
- Payments necessary to prevent the eviction of the employee from the employee's principal residence or mortgage foreclosure on that residence;
- Funeral expenses for the employee's deceased parent, spouse, etc.; or
- Certain expenses relating to the repair of damage to the employee's principal residence.

Nearly all 401(k) plans contain these conditions for determining whether a distribution is necessary to satisfy an employee's immediate and heavy financial need. These rules relieve the employer (and the employee) from looking at resources outside the 401(k) plan.

A hardship distribution described in the first, third and fifth bullets, above, can be made to a participant based on a grandchild's or domestic partner's need if that individual has been designated as a plan beneficiary, if this option is included in your plan document.

You may not treat a distribution as necessary to satisfy an immediate and heavy financial need:

- if the distribution exceeds the amount needed to relieve the employee's financial need, or
- if the financial need may be satisfied from other resources reasonably available to the employee.

You generally make this determination based on all relevant facts and circumstances. The law deems the employee's resources to include those assets of the employee's spouse and minor children that are reasonably available to the employee. Thus, for example, a vacation home owned by the employee and the employee's spouse generally will be deemed a resource of the employee. The amount of an immediate and heavy financial need may include any amounts necessary to pay any federal, state or local income taxes or penalties that reasonably result from the distribution.

You generally may treat an immediate and heavy financial need as not capable of being relieved from other resources reasonably available to the employee if you rely on the employee's written representation, unless you have actual knowledge to the contrary, that the need can't reasonably be relieved:

- through reimbursement or compensation by insurance or otherwise;
- by liquidating the employee's assets;
- by ceasing elective deferrals or employee contributions under the plan; or
- by other distributions or nontaxable loans from plans maintained by the employer or by any other employer, or by borrowing from commercial sources on reasonable commercial terms in an amount sufficient to satisfy the need.

A need can't reasonably be relieved by one of the actions listed above if the effect would be to increase the amount of the need. For example, a plan loan can't reasonably relieve the need for funds to purchase a principal residence if the loan would disqualify the employee from obtaining other necessary financing.

It's important that you keep a record of all information used to determine whether a participant was eligible for a hardship distribution and the amount distributed was the amount necessary to alleviate the hardship.

Hardship distributions may be subject to the 10% early distribution tax on distributions made prior to reaching age 59 ½.

How to find the mistake:

Review your plan document to determine if it allows hardship distributions, then review your 401(k) plan hardship procedures. If you don't have procedures for reviewing hardship applications, establish them possibly with the help of a benefits professional.

Review all distributions made during the year and determine which may have been a hardship distribution. For each hardship distribution, make a determination whether each one met the hardship distribution requirements in the plan document. Look for abuse of the hardship feature. If most of your hardship requests come from a specific group of employees, you may have some participants abusing the hardship feature.

How to fix the mistake:

Corrective action:
If the plan document doesn't allow for hardship distributions, but, in operation, hardship distributions do occur, then correction may involve a retroactive amendment to allow hardship distributions.

If hardship distributions are made to participants that don't meet the plan document hardship requirements or the 401(k) rules, then correction may involve a repayment to the plan of the amounts that didn't meet the plan hardship requirements or Section 401(k).

Example 1:
Employer L maintains a 401(k) plan with 40 participants. Plan provisions don't allow for hardship distributions. Employer L made hardship distributions to some employees during the 2011 and 2012-plan years. During a review of its plan operations, Employer L determined that it had made these hardship distributions available to all employees and that it had met the rules for hardship distributions.

Correction programs available:

Self-Correction Program:
This mistake is considered an operational error. If L determines it has practices and procedures in place to promote the overall compliance of their plan, it may correct the mistake under SCP. Although, in general, correction of an operational error through plan amendment isn't permissible under SCP, the provision of hardship withdrawals under the plan in a nondiscriminatory manner is one of four instances in which EPCRS allows a corrective amendment under SCP.

Correction would include adopting a retroactive plan amendment, effective January 1, 2011, to provide for the hardship distributions that Employer L made available. The amendment must provide that the hardship distribution option is nondiscriminatory.

Voluntary Correction Program:
Employer L may also correct the mistake under VCP by adopting a retroactive plan amendment, effective January 1, 2011, to provide for the hardship distributions it made available. The amendment must provide that the plan make the hardship distribution option nondiscriminatory. The fee for the VCP submission, based on a 40-person plan is $1,000. When L makes its VCP submission, it must include Forms 8950 and 8951 and should consider using the model documents in Revenue Procedure 2013-12 Appendix C.

Audit Closing Agreement Program:
Employer L may also correct this error under Audit CAP (see example 3).

Example 2:
Same facts as Example 1, except Employer L didn't make the distributions available to all employees and only made a hardship distribution to an HCE.

Correction programs available:

Self-Correction Program:
Since Employer L didn't make hardship distributions available to all employees, correction by retroactive amendment under SCP isn't available. An alternative correction that's reasonably designed to comply with section 6 of Revenue Procedure 2013-12 will be permitted.

Voluntary Correction Program:
Employer L may correct the mistake under VCP. However, since Employer L didn't make the hardship distributions available to all employees and only made them available to select highly compensated employees, EPCRS doesn't permit a retroactive plan amendment to correct this mistake because it won't satisfy the nondiscrimination rules. An alternative correction that's reasonably designed to comply with section 6 of Revenue Procedure 2013-12 will be permitted. The fee for the VCP submission in this case is $1,000).

Audit Closing Agreement Program:
Employer L may also correct this error under Audit CAP (see example 3).

Example 3:
Employer M maintains a 401(k) plan with 7,500 participants. Plan provisions allow for hardship distributions to participants. During a review of its operations, Employer M determined that 10 hardship distributions made during the 2012-plan year didn't have proper documentation and it didn't base five distributions on any hardship, but were nothing more than in-service distributions. No written procedures were in place to review a participant's application for a hardship distribution.

Correction programs available:

Self-Correction Program:
This mistake may not be eligible to correct under SCP since no adequate practices and procedures for hardship distributions were in place.

Voluntary Correction Program:
Employer M may correct this mistake under VCP. M must request that the five participants who received distributions not meeting the plan hardship requirements repay the amounts plus earnings to the plan. In addition, M must improve its hardship administrative procedures. Expecting participants to repay these amounts may pose a problem because the participants may have already spent the funds. A plan document requiring spousal consent for distributions, plus possible tax issues on the distributions could further complicate the final correction. Correction will depend on the facts and circumstances of each situation and may include, in some form, paybacks, employer corrective contributions and plan amendments. If this represents your situation, file a VCP submission and work with the IRS agent to determine the proper correction. The fee for the VCP submission for a 7,500-person plan is $20,000.

Audit Closing Agreement Program:
Most plans are eligible for Audit CAP, which allows the plan sponsor to correct the mistake and pay a negotiated sanction. This sanction will bear a reasonable relationship to the nature, extent and severity of the mistake, considering many factors, including the extent to which correction occurred before audit. Sanctions under Audit CAP are a negotiated percentage of the maximum payment amount.

How to avoid the mistake:

- Review the plan document language to determine when and under what circumstances you can make distributions.
- When you amend your plan document, make certain the language for hardship distributions is in the most recent document.
- Establish hardship distribution procedures working with your benefits professional to determine if these procedures are sufficient to avoid mistakes.
- Only allow hardship distributions that meet the plan document and IRC Section 401(k) requirements.
- Look for signs that the hardship distribution program is being abused or badly managed.
    - Too many hardship requests by one group or division may be a sign of abuse.
    - Requests for hardship distributions from multiple employees appear identical. Each situation should have its own individual circumstances.
    - Only the highly compensated employees have hardship distributions. This may be a sign that rank-and-file employees haven't been properly notified of the availability of hardship distributions.

Return to Table

Mistake	Find the Mistake	Fix the Mistake	Avoid the Mistake
The plan was top-heavy and the required minimum contributions weren't made to the plan.	Review the rules and definitions for top-heavy in your plan document. Determine whether your plan is top-heavy for the plan year.	Properly contribute and allocate the required top-heavy minimum, adjusted for earnings, to the affected non-key employees.	Perform a top-heavy test each year.

11) The plan was top-heavy and required minimum contributions weren't made to the plan.

The top-heavy rules generally ensure that the lower paid employees receive a minimum benefit if the plan is top-heavy. A plan is top-heavy when, as of the last day of the prior plan year, the total value of the plan accounts of key employees is more than 60% of the total value of the plan assets.

If a 401(k) plan is top-heavy, the employer must contribute up to 3% of compensation for all non-key employees still employed on the last day of the plan year. This contribution is subject to a vesting schedule requiring participants to be 100% vested after three years; or 20% after 2 years, 40% after 3, 60% after 4, 80% after 5 and 100% after 6 years.

Key employee: To determine if your plan is top-heavy, you must identify key employees - any employee (including former or deceased employees), who at any time during the plan year was:

- An officer making over $170,000 (2014);
- A 5% owner of the business (a 5% owner is someone who owns **more** than 5% of the business), **or**
- An employee owning more than 1% of the business and making over $150,000.

A non-key employee is everyone else.

Remember, when you're determining ownership interests, family aggregation rules apply. These rules may affect the treatment of stock owned directly or indirectly by family members. The rules treat any individual who is a spouse, child, grandparent or parent of someone who is a 5% owner, or who, together with that individual, would own more than 5% of a company's stock as a 5% owner. As a 5% owner, the law considers each of these individuals a key employee for the plan year. It's important to identify the family ownership interests of all company stock and to forward that information to your TPA, advisor or person performing the nondiscrimination tests.

SIMPLE 401(k) plans and certain safe harbor 401(k) plans aren't subject to the top-heavy rules.

How to find the mistake:

Review the top-heavy rules and definitions in your plan document. Determine if your plan is top-heavy each plan year. Be careful to properly identify owners and their family members.

It's common for a 401(k) plan to be top-heavy, especially for smaller plans and plans with high turnover. If you've been operating a 401(k) plan covering only you and your spouse, and you hire other employees who become eligible under the plan, you'll probably have to make required minimum contributions if the new employees are non-key employees.

It's important to note the distinction between key employees, who count for top-heavy purposes, and highly compensated employees, who count for the ADP and ACP tests, but not the top-heavy tests.

How to fix the mistake:

Corrective action:
The employer must make a corrective contribution that includes lost earnings to the non-key employees. The contribution is generally 3% of compensation.

Example:
Employer J, a husband and wife business, have sponsored a 401(k) plan since 2002. As business expanded, they hired two employees on July 31, 2010. According to the plan document, both new employees became eligible for the 401(k) plan on January 1, 2012. Both new employees made elective deferrals to the plan and it passed the ADP test for both 2012 and 2013. During a review of the plan, Employer J determined the plan was top-heavy for the 2012 and 2013 plan years; however, J didn't make minimum top-heavy contributions.

Correction programs available:

Self-Correction Program:
The example shows an operational problem because the employer didn't follow the plan's top-heavy provisions. If the other eligibility requirements of SCP are satisfied, Employer J may use SCP to correct the failure.

- No fees for self-correction.
- Practices and procedures must be in place.
- If the mistakes are **significant** in the aggregate:
  - Employer J needs to make corrective contributions for the 2012 plan year by the end of 2014. J needs to make the corrective contribution for the mistake that occurred in 2013 by December 31, 2015.
- If the mistakes are **insignificant** in the aggregate, Employer J can correct beyond the two-year correction period. Whether a mistake is insignificant depends on all facts and circumstances.

Voluntary Correction Program:
Correction is the same as under "Corrective action." Employer J makes a VCP submission per Revenue Procedure 2013-12. The fee for the VCP submission is $750. When making the VCP submission, J should include Forms 8950 and 8951 and consider using the model documents in Revenue Procedure 2013-12 Appendix C.

Audit Closing Agreement Program:
Under Audit CAP, correction is the same as under "Corrective action." Employer J and the IRS enter into a closing agreement outlining the corrective action and negotiate a sanction based on the maximum payment amount.

How to avoid the mistake:

- Perform a top-heavy test annually.
- Take care to identify ownership interests under the family aggregation rules so the test is accurate. Be especially careful if you have a smaller plan or one that only covered owners for a period of time and now has other participants.

Return to Table

Mistake	Find the Mistake	Fix the Mistake	Avoid the Mistake
You haven't filed a Form 5500-series return this year.	Find your signed copy of the return and determine if you filed it timely.	File all delinquent returns.	Understand your filing requirement and know who filed and when. Don't assume someone is taking care of it.

12) You haven't filed a Form 5500-series return this year.

ERISA and the Internal Revenue Code require many employers and plan administrators to submit reports to government agencies and furnish certain plan information to participants. Most 401(k) plan sponsors are required to file an annual Form 5500, *Annual Return/Report of Employee Benefit Plan*. For an explanation of how to file your Form 5500 return, in addition to the EFAST electronic filing requirements, visit www.efast.dol.gov.

Very small employers whose employees are limited to owners or partners and their spouses must file Form 5500-EZ with the IRS for any year in which plan assets exceed $250,000 ($100,000 for years prior to 2007).

All plan sponsors, regardless of plan asset value, must file a final return for the year their plan is terminated and all assets distributed.

How to find the mistake:

Many employers identify the mistake of not filing an annual Form 5500-series return when they receive a letter from IRS or DOL stating the employer didn't file one. It's normally a year after it was due and includes a substantial penalty. Late filed returns are subject to penalties from both IRS and DOL, so it's very important to identify this mistake before we do.

- The IRS penalty for late filing of a 5500-series return is $25 per day, up to a maximum of $15,000.
- The DOL penalty for late filing can run up to $1,100 per day, with no maximum.

To identify this mistake, find your signed copy of the return, and determine if it you filed it timely.

How to fix the mistake:

Correction of a late filed Form 5500-series return isn't available under EPCRS. If you determine you didn't file your Form 5500-series return, correct by filing the delinquent return as soon as possible. DOL maintains a Delinquent Filer Voluntary Correction Program (DFVC) that's available to plans that are subject to Title 1 of ERISA. IRS has a temporary pilot penalty relief program for sponsors of certain non-ERISA plans required to file Form 5500-EZ who are late filers.

Example:
Employer Z sponsors a 401(k) for its employees and failed to file a Form 5500-series return for the 2012 year.

Corrective action:
Employer Z can't correct failing to file a Form 5500 return under EPCRS. If the IRS contacts Employer Z about its delinquent Form 5500-series return, Z may file it in response to the letter. Z should Include an explanation of why it didn't file the return and request a waiver of the penalty. If the IRS hasn't assessed any penalties and the plan is subject to ERISA, Z may use

the Department of Labor's DFVC Program. If Z uses this program, IRS won't pursue any late filing penalties if Z meets certain conditions.

If Employer Z sponsors a one-participant plan, Z can file a Form 5500-EZ with the IRS. Z should include an explanation of why the return(s) were filed late and request a waiver of the penalty. If IRS hasn't assessed penalties, then Z should consider using the IRS Form 5500-EZ temporary pilot penalty relief program.

How to avoid the mistake:

- Understand your responsibility to file the return. The plan administrator has the responsibility for ensuring that the return is filed timely. Never assume someone else is filing the return for you.
- Make an identified person or outside service provider responsible for timely filing the return.
- Use a calendar (tickler file) that notes the deadline for filing the return; and implement a communication mechanism to alert the plan administrator and any outside service providers of the upcoming deadline to file.