Section 401(k) and(m)-ADP/ACP Tests-Correction Methods under EPCRS

CPE 2013

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INTERNAL REVENUE SERVICE
TAX EXEMPT AND GOVERNMENT ENTITIES

Overview

Introduction

This chapter will cover 401(k) and (m) correction methods under the Employee Plans Compliance Resolution System (EPCRS). EPCRS allows plan sponsors to correct failures for plans satisfying section 401(a), including section 401(k).

This chapter will cover correction methods for Average Deferral Percentage (ADP)/Average Contribution Percentage (ACP) failures, Section 402(g) failures, improperly excluding employees, improperly excluding employees' catch-up and matching contributions, failure to implement employees' elections, and coordination with correction of other failures.

Objectives

At the end of this lesson, you should be able to:

- Determine whether an employer correctly applied the ADP/ACP test.
- Determine whether an employer timely corrected for an ADP/ACP test failure.
- State the correction methods under Revenue Procedure (Rev. Proc.) 2008-50 when a plan does not timely correct for failing the ADP/ACP test.
- Determine whether the employer made the correct Qualified Non-elective Contributions (QNECs)/Qualified Matching Contributions (QMACs) under Rev. Proc. 2008-50.
- Determine whether the employer properly applied the one-to-one correction method.
- Determine whether the employer properly coordinated multiple failures under a section 401(k) plan.

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Failure to Satisfy the ADP/ACP Test

Introduction

Rev. Proc. 2008-50, Section .03 of Appendix A provides that one permitted correction method for failing to timely correct the ADP/ACP test failures is to make QNECs (QMACs). Section 2.01(1)(b)(i) of Appendix B provides that, in addition to the QNEC correction method, the ADP/ACP test can be corrected by the "one to one" correction method. This chapter will discuss these correction methods.

QNEC Correction Method

If you determine on examination that the plan fails the ADP/ACP tests and the time for correcting the failure has passed, this operational qualification failure must be corrected using EPCRS methods.

Correction Methods under the Regulations

Time for Correction

An ADP/ACP failure must be corrected within 12 months after the end of the plan year in which there were excess contributions. If this is not timely corrected, the cash or deferred arrangement will not satisfy §401(k)(3) for the plan year for which there were excess contributions and for all subsequent plan years that these excess contributions remain in the trust.

Example 1

You are auditing the Gulf Coast Profit Sharing Plan with a 401(k) feature for the 2009 plan year. The Plan files its Form 5500 on a calendar year basis. You discover the Plan failed the ADP test for 2009 and did not correct.

Since the excess contributions arose in 2009, the plan was required to correct by the end of 2010. Since the plan did not correct, the plan is required to use one of the correction methods under EPCRS to remain qualified.

Types of Correction

Under the regulations, there are three types of available corrections for an ADP and/or ACP failure:

- QNECs or QMACs,
- Excess contributions distributed, and
- Excess contributions recharacterized.

Prior Year Method

If a plan is using the prior year method, the plan will probably miss the deadline for making QNECs or QMACs and would have to use distribution or recharacterization correction methods. The deadline for allocating QNECs or QMACs is 12 months after the applicable year for the non-highly compensated employees (NHCEs).

The applicable year is generally the year in which the ADP is determined for both NHCEs and highly compensated employees (HCEs). For plans using the prior year method, the ADP for the NHCEs is determined in the year prior to the year the ADP test is being run.

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Correction Methods under the Regulations, Continued

Example 2

A 401(k) plan is using the prior year method. The testing year is 2011, and in February, 2012, the plan was discovered to have failed the ADP test. The NHCE ADP was 3% for 2010 and the HCE ADP for 2011 was 6%.

The deadline for allocating QNECs relates to the year for which the NHCE ADP is used for the ADP test. The applicable year for the NHCE ADP is 2010. As a result, the deadline for allocating QNECs is 12/31/2011. Since the ADP test was completed in February 2012, the deadline for allocating QNECs has passed. The correction methods of either distribution or recharacterization of excess contributions can be used and must be completed within 12 months after the testing year or 12/31/2012. If the correction is not completed by that date, the correction methods per Rev. Proc. 2008-50 are available to the plan.

Correction Method under EPCRS-QNEC

Introduction

If a plan was not timely corrected for the failed ADP/ACP test, the plan must use one of two correction methods:

- QNECs (QMACs) or
- The "one-to-one" correction method.

QNECs

Section .03 of Appendix A permits an employer to make QNECS for NHCEs to the extent necessary to raise the ADP or ACP of the NHCEs to the percentage needed to pass the test or tests. The contributions must be made for all eligible NHCEs and must be for the same percentage of compensation. QNECs contributed to satisfy the ADP test do not have to be considered for determining additional contributions, such as matching contributions.

Example Illustrating QNECs under Rev. Proc. 2008-50

Example 3

You are examining a section 401(k) plan and discover that the plan failed the ADP test in 2010. The plan is a calendar year plan. Correction was not made by 12/31/2011, and the employer decides to contribute QNECs under Rev. Proc. 2008-50. The employer has two HCEs and 17 NHCEs. The HCE ADP was 7% and the NHCE ADP was 1.94%.

The employer states that the ADP/ACP tests were not completed for 2010 because the employer changed third-party plan administrators. The employer is not certain whether the ADP/ACP tests were completed for previous years. Although the audit would be expanded in this case, this example will only illustrate the 2010 plan year.

The current year method is used for ADP/ACP testing. Interest would be calculated from the date of the failure (12/31/2011) through the date of correction (assume 7/1/2012). Also assume a 4% rate of return on plan assets for 2012. The adjustment for earnings for 1/2 the year is 2%.

The table below shows the elective deferrals for 17 NHCEs, with an NHCE ADP of 1.94%.

Defect was not Corrected

The defect was not corrected until after the examination began.

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Example Illustrating QNECs under Rev. Proc. 2008-50,
Continued

Table I-NHCEs – 2010

	Compensation	Elective Deferral Percentage	Elective Contribution
Adam	$45,000	0%	$0.00
Brenda	$55,000	2%	$1,100.00
Christine	$60,000	2%	$1,200.00
Debbie	$52,000	0%	$0.00
Dick	$73,000	3%	$2,190.00
Gwen	$58,000	2%	$1,160.00
Harold	$47,000	0%	$0.00
Harry	$82,000	4%	$3,280.00
Jane	$77,000	4%	$3,080.00
Leah	$59,000	3%	$1,770.00
Mary	$66,000	0%	$0.00
Max	$85,000	4%	$3,400.00
Nancy	$92,000	4%	$3,680.00
Sophie	$94,000	2%	$1,880.00
Steven	$85,000	1%	$850.00
Stuart	$68,000	0%	$0.00
Tom	$62,000	2%	$1,240.00
Total		33.00%	$24,830.00
Average		**1.94%**	

Table II – HCEs – 2010

HCEs	Compensation	Elective Deferral Percentage	Elective Contribution
Jed	$130,000	7%	$9,100.00
Seymour	$150,000	7%	$10,500.00
Average		**7%**	

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ADP Test

The plan fails the ADP test for 2010. Since there are two prongs to the ADP test, the HCE ADP must be less than or equal to the greater of:

- 125% of the NHCE ADP, or
- The lesser of 2+ or 2x the NHCE ADP.

The NHCE ADP as calculated above in table I is 1.94%. Applying the ADP test, the HCE ADP cannot be greater than:

- 1.94% x 1.25% or 2.43% or
- The lesser of 2+1.94% (3.94%) or 2x 1.94% (3.88%) or 3.88%.

Since the HCE ADP of 7% is greater than 3.88%, the plan fails the ADP test.

QNECs

Since correction was not made within 12 months after the excess contributions arose, or by 12/31/2011, the employer decides to make QNECs under Rev. Proc. 2008-50.

To satisfy the ADP test, the NHCE ADP has to be raised to 5% for the plan to pass the ADP test with an HCE ADP of 7%.

Remember, with QNECs, we start with the HCE ADP of 7%, and calculate the necessary NHCE ADP percentage. We have to work backwards to determine what the NHCE ADP would be to satisfy the ADP test with an HCE ADP of 7%.

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Example Illustrating QNECs under Rev. Proc. 2008-50,
Continued

Applying the ADP Test

With a HCE ADP of 7%, what is the lowest percentage that the NHCE ADP can be and still pass the ADP test? Remember there are two prongs, with one prong having two parts:

> First divide 7% by 1.25% to get 5.6%.
>
> Then divide 7% by 2 to get 3.5%.
>
> Finally, subtract 2% from 7% to get 5%.

Assuming an NHCE ADP of 3.5%

If the NHCE ADP were 3.5%, the ADP test would be:

> 3.5% x 1.25% or 4.38%.
>
> The HCE ADP test must be the lower of 3.5% +2% or 5.5% or 3.5% x 2% or 7%.

Since the actual HCE ADP is 7%, a NHCE ADP of 3.5% would not satisfy the ADP test because the HCE ADP cannot exceed 5.5%.

Assuming an NHCE ADP of 5%

If the NHCE ADP were 5%, the ADP test would be:

> 5% x 1.25% or 6.25%.
>
> The HCE ADP must be the lower of 5% +2% or 7% or 5% x 2 or 10%. The HCE ADP can be 7% with a NHCE ADP of 5%.

Raising the NHCE ADP to 5% would allow the plan to satisfy the ADP test with an HCE ADP of 7%.

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Example Illustrating QNECs under Rev. Proc. 2008-50,
Continued

Assuming an NHCE ADP of 5.6%

If the NHCE ADP were 5.6%, the ADP test would be:

5.6% x 1.25% or 7%.

The HCE ADP must be the lower of 5.6% + 2% (7.6%) or 5.6% x 2 (11.2%).

Raising the NHCE ADP to 5.6% would also allow the plan to satisfy the ADP test. However, since 5% is less than 5.6%, the employer can use 5% to calculate the QNECs for each NHCE.

Calculating the QNEC

Each employee must receive a contribution equal to the same percentage of compensation. Since the NHCE ADP is 1.94%, each NHCE can be treated as contributing 1.94% as an elective deferral. Since there are 17 employees and the average is 1.94%, each employee must be given 3.06% for the plan to pass the ADP test. The 3.06% represents the difference between 5% and 1.94%.

To raise the NHCE actual deferral ratio to 5%, each NHCE must be given 3.06%, the difference between 5% and 1.94%.

Table III-QNEC Calculation

EE	Salary	Elective Deferral Percentage	Elective Contribution	QNEC Percentage	QNEC-Dollar Contribution	Total Percentage	Earnings	Total Contribution
Adam	$45,000	0%	$0.00	3.06%	$1,377.00	3.06%	$27.54	$1,404.54
Brenda	$55,000	2%	$1,100.00	3.06%	$1,683.00	5.06%	$33.66	$1,716.66
Christine	$60,000	2%	$1,200.00	3.06%	$1,836.00	5.06%	$36.72	$1,872.72
Debbie	$52,000	0%	$0.00	3.06%	$1,591.20	3.06%	$31.82	$1,623.02
Dick	$73,000	3%	$2,190.00	3.06%	$2,233.80	6.06%	$44.68	$2,278.48
Gwen	$58,000	2%	$1,160.00	3.06%	$1,774.80	5.06%	$35.50	$1,810.30
Harold	$47,000	0%	$0.00	3.06%	$1,438.20	3.06%	$28.76	$1,466.96
Harry	$82,000	4%	$3,280.00	3.06%	$2,509.20	7.06%	$50.18	$2,559.38
Jane	$77,000	4%	$3,080.00	3.06%	$2,356.20	7.06%	$47.12	$2,403.32
Leah	$59,000	3%	$1,770.00	3.06%	$1,805.40	6.06%	$36.11	$1,841.51
Mary	$66,000	0%	$0.00	3.06%	$2,019.60	3.06%	$40.39	$2,059.99
Max	$85,000	4%	$3,400.00	3.06%	$2,601.00	7.06%	$52.02	$2,653.02
Nancy	$92,000	4%	$3,680.00	3.06%	$2,815.20	7.06%	$56.30	$2,871.50
Sophie	$94,000	2%	$1,880.00	3.06%	$2,876.40	5.06%	$57.53	$2,933.93
Steven	$85,000	1%	$850.00	3.06%	$2,601.00	4.06%	$52.02	$2,653.02
Stuart	$68,000	0%	$0.00	3.06%	$2,080.80	3.06%	$41.62	$2,122.42
Tom	$62,000	2%	$1,240.00	3.06%	$1,897.20	5.06%	$37.94	$1,935.14
Total					**$35,496.00**	**85.02%**	**$709.92**	**$36,205.92**
Average						**5.00%**		

Explanation of Table

In the table above, each NHCE was given the same QNEC of 3.06%, which meets the requirements of Rev. Proc. 2008-50. When this contribution is added to the elective deferrals (i.e., ADP of 1.94%) that the NHCEs already made, the NHCE ADP is 5%. Thus, the contribution of 3.06% for each NHCE allows the plan to satisfy the ADP test with an HCE ADP of 7%.

Adjustment for Earnings

The adjustment for earnings would be calculated:

The total QNEC of $35,496 would be multiplied by 2% or $710. There would be an additional allocation of 2% multiplied by the amount of the QNEC for each NHCE. Section 3 of Appendix B of Rev. Proc. 2008-50 provides alternative methods for allocating earnings.

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Example Illustrating QNECs under Rev. Proc. 2008-50,
Continued

Matching Contributions

QNECs used to satisfy the ADP test do not have to be considered when determining additional contributions, such as matching contributions. However, employees who would have received the matching contribution had they made elective deferrals must be counted as eligible employees for the ACP test. The plan must satisfy the ACP test.

Example Illustrating Matching Contributions

Example 4 Same facts as previous example, except that the plan provides a matching contribution formula:

- 100% up to the first 2% of compensation,
- 50% for the next 5% of compensation.

You have discovered that the plan did not run an ACP test for the 2010 plan year.

Table I-Matching Contributions

	Compensation	Elective Deferral Percentage	Elective Contribution	Matching Contribution Percentage	Matching Contributions
Adam	$45,000	0%	$0.00	0.00%	$0.00
Brenda	$55,000	2%	$1,100.00	2.00%	$1,100.00
Christine	$60,000	2%	$1,200.00	2.00%	$1,200.00
Debbie	$52,000	0%	$0.00	0.00%	$0.00
Dick	$73,000	3%	$2,190.00	2.50%	$1,825.00
Gwen	$58,000	2%	$1,160.00	2.00%	$1,160.00
Harold	$47,000	0%	$0.00	0.00%	$0.00
Harry	$82,000	4%	$3,280.00	3.00%	$2,460.00
Jane	$77,000	4%	$3,080.00	3.00%	$2,310.00
Leah	$59,000	3%	$1,770.00	2.50%	$1,475.00
Mary	$66,000	0%	$0.00	0.00%	$0.00
Max	$85,000	4%	$3,400.00	3.00%	$2,550.00
Nancy	$92,000	4%	$3,680.00	3.00%	$2,760.00
Sophie	$94,000	2%	$1,880.00	2.00%	$1,880.00
Steven	$85,000	1%	$850.00	1.00%	$850.00
Stuart	$68,000	0%	$0.00	0.00%	$0.00
Tom	$62,000	2%	$1,240.00	2.00%	$1,240.00
Total		33.00%	$24,830.00	28.00%	$20,810.00
Average		**1.94%**		**1.65%**	

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Example Illustrating Matching Contributions, Continued

Table I Matching Contributions Cont'd

	Compensation	Elective Deferral Percentage	Elective Contribution	Matching Contribution Percentage	Matching Contributions
Jed	$130,000	7%	$9,100.00	4.50%	$5,850.00
Seymour	$150,000	7%	$10,500.00	4.50%	$6,750.00
Average		**7%**		**4.50%**	

Applying the ACP Test

The ACP test is the same as the ADP test; the HCE ACP has to be the greater of two prongs:

- 125% of the NHCE ACP or
- the lesser of 2x the NHCE ACP or 2+ the NHCE ACP.

The plan fails the ACP test since 4.5% is greater than:

- 125% of 1.65% or **2.06%,**
- the lesser of 2x 1.65% (3.30%) or 2+1.65% (3.65%)--**3.3%.**

QNECs

Section .03, Appendix A of Rev. Proc. 2008-50 permits an employer to make a QNEC for NHCEs to raise the NHCE ACP to the extent necessary to pass the ACP test. As with the QNECs for the ADP test, the contributions must be made for all eligible NHCEs and must be the same percentage of compensation.

To calculate the NHCE ACP, the HCE ACP is used to determine the NHCE ACP. Working backwards, the NHCE ACP for the 2 prongs, assuming 4.5% is the HCE ACP. Applying the prongs:

- 4.5%/1.25 or 3.6%.
- 4.5%/2 or 2.25%.
- 4.5%-2% or 2.5%.

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Example Illustrating Matching Contributions, Continued

Assuming the NHCE ACP is 3.6%

Applying the ACP test, if the NHCE ACP was 3.6%, the HCE ACP would be:

- 3.6% x 1.25 or 4.5%,
- the lesser of 3.6% x 2 (7.2%) or 3.6%+2 (5.6%) or 5.6%.

Using 3.6% would allow the plan to satisfy the ACP test.

Assuming the NHCE ACP is 2.25%

In the ACP test, if the NHCE ACP was 2.25%, the HCE ACP would be:

- 2.25% x 1.25 or 2.81%.
- The lesser of 2.25% +2% (4.25%) or 2.25%x 2 (4.5%) or 4.25%. Since the actual HCE ACP is greater than 4.25%, the NHCE ACP of 2.25% cannot be used.

Assuming the NHCE ACP is 2.5%

If the NHCE ACP is 2.5%, the HCE ACP would be:

- 2.5% x 1.25 or 3.13%.
- The lesser of 2.5% +2% (4.5%) or 2.5% x 2 (5%) or 4.5%.

Since the actual HCE ACP is 4.5%, a NHCE ACP of 2.5% would allow the plan to satisfy the ACP test.

Calculating the QNEC

Since the NHCE ACP is 1.65%, each NHCE can be treated as receiving a matching contribution of 1.65% of compensation. To raise each NHCE actual contribution ratio to 2.5%, each NHCE must be given .85%, the difference between 2.5% and 1.65%.

Table II--Calculating QNECs

	Compensation	Elective Deferral Percentage	Matching Contribution Percentage	Matching Contributions	QNEC %	Total Match and QNEC	QNEC	Earnings
Adam	$45,000	0%	0.00%	$0.00	0.85%	0.85%	$383	$7.66
Brenda	$55,000	2%	2.00%	$1,100.00	0.85%	2.85%	$468	$9.36
Christine	$60,000	2%	2.00%	$1,200.00	0.85%	2.85%	$510	$10.20
Debbie	$52,000	0%	0.00%	$0.00	0.85%	0.85%	$442	$8.84
Dick	$73,000	3%	2.50%	$1,825.00	0.85%	3.35%	$621	$12.42
Gwen	$58,000	2%	2.00%	$1,160.00	0.85%	2.85%	$493	$9.86
Harold	$47,000	0%	0.00%	$0.00	0.85%	0.85%	$400	$8.00
Harry	$82,000	4%	3.00%	$2,460.00	0.85%	3.85%	$697	$13.94
Jane	$77,000	4%	3.00%	$2,310.00	0.85%	3.85%	$655	$13.10
Leah	$59,000	3%	2.50%	$1,475.00	0.85%	3.35%	$502	$10.04
Mary	$66,000	0%	0.00%	$0.00	0.85%	0.85%	$561	$11.22
Max	$85,000	4%	3.00%	$2,550.00	0.85%	3.85%	$723	$14.46
Nancy	$92,000	4%	3.00%	$2,760.00	0.85%	3.85%	$782	$15.64
Sophie	$94,000	2%	2.00%	$1,880.00	0.85%	2.85%	$799	$15.98
Steven	$85,000	1%	1.00%	$850.00	0.85%	1.85%	$723	$14.46
Stuart	$68,000	0%	0.00%	$0.00	0.85%	0.85%	$578	$11.56
Tom	$62,000	2%	2.00%	$1,240.00	0.85%	2.85%	$527	$10.54
Total						42.45	$9,860	$197.28
Average		**1.94%**	**1.65%**			**2.50%**		

Explanation of Table

In the table above, each NHCE was given the same QNEC of .85%, which meets the requirements of Rev. Proc. 2008-50. When this contribution is added to the matching contributions that the NHCEs received (i.e. NHCE ACP% of 1.65%), the NHCE ACP is 2.5%. The contribution of .85% for each NHCE allows the plan to satisfy the ACP test with an HCE ACP of 4.5%.

SCP vs. CAP

Introduction

Whether the above defect is significant or insignificant is based on many factors. This example illustrates significant defects because of the following factors.

Multiple Failures

There are multiple failures. As will be discussed below, the plan also incorrectly excluded 5 employees who were eligible to make elective deferrals. Consequently, there are two main failures, the ADP/ACP failures and the incorrect exclusion of five employees.

Percentage of Plan Assets Involved in the Failure

The percentage of plan assets and contributions involved in the failure is significant. $24,830 was deferred for the NHCEs. The QNECs, as calculated below, are $35,496, with $710 earnings. Since the necessary QNECS exceed the elective deferrals, the failure is significant.

Excess Contributions are Significant

If the one-to-one method was used, the excess contributions would be $8,900 of $19,600, which is 45% of the total elective deferrals made by the HCEs.

The excess contributions are also significant in the NHCE elective contributions: $8,900 of $24,830, which is 36%.

Number of Employees Affected by the Failure

The number of NHCEs affected by the failure is 15 of a total of 15, or 100%. If the one-to-one method was used, all employees, including the HCEs, would be affected by this ADP/ACP failure.

One-to-One Correction Method

Introduction

If a plan fails the ADP/ACP test and the plan is not timely corrected, Rev. Proc. 2008-50 permits the "one-to-one" correction method. Under this method, an excess contribution amount is determined and assigned to the HCEs. This amount, adjusted for earnings, is either distributed to the HCEs or forfeited from the HCEs' accounts.

That same excess contribution amount, with earnings, is contributed to the plan and allocated to NHCEs. The contribution must satisfy the vesting requirements and distribution limitations of section 401(k)(2)(B) and (C).

See Section 2.01(b)(iv)(A) of Appendix B.

Section 401(k)(2)(B)

Under section 401(k)(2)(B), the distribution restrictions are that these contributions may not be distributed to participants or beneficiaries earlier than:

- severance from employment, death, or disability,
- an event described in section 401(k)(10),
- with a profit-sharing or stock bonus plan, the attainment of age 59 1/2,
- with contributions to a profit-sharing or stock bonus plan to which section 402(e)(3) applies, on hardship of the employee, or
- with a qualified reservist distribution as per section 72(t)(2)(G)(iii), the date on which a period per sub-clause (III) of subsection begins.

The distribution will not be distributable merely by completion of the stated participation period or the lapse of a fixed number of years.

Section 401(k)(2)(C)

Section 401(k)(2)(C) provides that an employee's right to his accrued benefit from employer contributions is nonforfeitable. Thus, the excess contributions will be 100% vested when the employer makes the plan contribution.

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Contributions to the NHCEs – Current Year Testing Method

For plans using the current year testing method, the contribution made under Section 2.01(b)(iv)(A) of Appendix B (the contribution of excess contributions determined below) is allocated to the account balances of:

- eligible NHCEs for the year of the failure or
- eligible NHCEs for the year of the failure who are also NHCEs for the year of correction.

Alternatively, the contribution is only allocated to the eligible employees' accounts (see bullets above), who were employed on a date during the year of correction that is no later than the date of correction.

Regardless of which one of these four options is used, eligible employees must receive a uniform allocation of the contribution as a percentage of compensation.

Prior Year Testing Method

For plans using the prior year method, the account balances to be increased are those balances that made up the NHCE ADP for the prior year. The contribution of the excess contribution is allocated to the account balances of those individuals who were either:

- The eligible employees for the year prior to the year of the failure who were NHCEs for that year, or
- The eligible employees for the year prior to the year of the failure who were NHCEs for that year and who are also NHCEs for the year of correction.

Alternatively, the contribution is allocated to accounts of these eligible employees employed on a date during the year of correction that is no later than the date of correction.

Regardless of which of the four options that the employer chooses, each must receive a uniform allocation (as a percentage of compensation) of the contribution.

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No Adjustment for Earnings

Under the one-to-one correction method, the amount allocated to the employee's account is not further adjusted for earnings and is treated as an annual addition under section 415 for the year of the failure.

Determining the Excess Contribution Amount

The excess contribution amount (not to be confused with terminology used for ACP failures) is equal to the excess of:

- The sum of excess contributions per section 401(k)(8)(B), and excess aggregate contributions per section 401(m)(6)(B), over
- Previous corrections that complied with 401(k)(8) and section 401(m)(6).

If there were no corrections for a plan year, the excess contribution amount is equal to the sum of the excess contributions or the sum of the excess aggregate contributions.

Example 5– Facts

Assume the same facts as in previous example.

Table I-NHCEs – for 2010

	Compensation	Elective Deferral Percentage	Elective Contribution
Adam	$45,000	0%	$0.00
Brenda	$55,000	2%	$1,100.00
Christine	$60,000	2%	$1,200.00
Debbie	$52,000	0%	$0.00
Dick	$73,000	3%	$2,190.00
Gwen	$58,000	2%	$1,160.00
Harold	$47,000	0%	$0.00
Harry	$82,000	4%	$3,280.00
Jane	$77,000	4%	$3,080.00
Leah	$59,000	3%	$1,770.00
Mary	$66,000	0%	$0.00
Max	$85,000	4%	$3,400.00
Nancy	$92,000	4%	$3,680.00

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Example 5– Facts (continued)

	Compensation	Elective Deferral Percentage	Elective Contribution
Sophie	$94,000	2%	$1,880.00
Steven	$85,000	1%	$850.00
Stuart	$68,000	0%	$0.00
Tom	$62,000	2%	$1,240.00
Total			
Average		**1.94%**	

Table II – HCEs

HCEs	Compensation	Elective Deferral Percentage	Elective Contribution
Jed	$130,000	7%	$9,100.00
Seymour	$150,000	7%	$10,500.00
Average		**7%**	

Calculating the Excess Contributions

To calculate the excess contributions, the plan must use the percentage leveling method. The NHCE ADP is 1.94%. The HCE ADP, to pass the ADP test, has to be the greater of:

- 1.94% x 1.25 (2.43%) or
- The lesser of 2+1.94% (3.94%) or 2x 1.94% (3.88%).

To determine the excess contributions, the HCE ADP must be reduced from 7% to 3.88% using the percentage leveling method. Since both Jed and Seymour have a 7% elective deferral percentage, their percentages are reduced equally until their elective deferral percentages equal 3.88%, the target percentage that will enable the plan to pass the ADP test.

Thus, both percentages are reduced from 7% to 3.88%. The excess contribution percentage is 3.12%, which is applied to both Jed and Seymour's salary.

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Total Excess Contributions

The total excess contributions are $8,736, which is calculated:

HCEs	Compensation	Elective deferral percentage	Elective contribution	Reduction percentage	Excess contribution
Jed	$130,000	7%	$9,100	3.12%	$4,056
Seymour	$150,000	7%	$10,500	3.12%	$4,680

Explanation of Table

Since the reduction to the elective deferral percentages of both Jed and Seymour was 3.12%, this percentage is then multiplied by their compensation to calculate each HCE's excess contribution. The total excess contribution is $8,736, which is the sum of Jed's excess contribution of $4,056 and Seymour's excess contribution of $4,680.

Dollar Leveling Method

Once the total excess contributions are determined, the dollar leveling method is used to determine the amount of excess contributions to be returned to each HCE as indicated below. Also, remember that earnings are calculated from the date of the failure (12/31/2011 through the date of correction (assuming 7/1/2012)).

	Elective Contribution	Excess Contribution determined under the % method	Dollar Leveling	Remaining Elective Contributions	Balance of Excess Contributions	Dollar Leveling	Remaining Elective Contributions	Total excess contrib.	Earnings
Jed	$9,100	$4,056	$0	$9,100		$3,668	$5,432	$3,668	$73.36
Seymour	$10,500	$4,680	$1,400	$9,100		$3,668	$5,432	$5,068	$101.36
Total	$19,600	$8,736	$1,400		$7,336	$7,336	$10,864	$8,736	$174.72

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Dollar Leveling Method

In the table above, Jed has elective contributions of $9,100 and Seymour has elective contributions of $10,500. Under the dollar leveling method, the HCE with the highest dollar amount of elective deferrals is corrected first. Thus, Seymour's elective contributions of $10,500 are reduced to the next level of elective contributions, or $9,100. As a result, Seymour receives $1,400 before Jed receives any distribution of elective deferrals.

Since the $1,400 does not eliminate all the excess contributions of $8,736, the dollar leveling method is used again. In this case, since both Jed and Seymour have elective contributions of $9,100, in this step, these elective contributions are reduced equally until the excess contributions are exhausted.

Since $7,336 remains, this amount is divided by two and is apportioned to both Jed and Seymour. With this step, Jed and Seymour will each receive $3,668. Since Seymour will already receive $1,400, Seymour will receive a total of $5,068 ($1,400+$3,668). See table above.

Earnings for the Excess Contributions

The date of correction is assumed to be7/1/2012, and the rate of earnings from the date of failure to the date of correction is 2%. As per the table above, the earnings on Seymour's excess contributions are $101.36, and the earnings on Jed's excess contributions are $73.36.

Total Contributions

The total amount of contributions required under the one- to- one correction method is $8,736 plus earnings of $174.72, or $8,910.72. This amount will be contributed by the employer and allocated among the employees who were eligible NHCEs on the date of failure, 12/31/2011.

Contribution and Allocation

The employer chooses to contribute the excess contributions, as calculated above, to the eligible NHCEs who were employees on the date of correction, 7/1/2012. Two employees who were eligible for the contribution, Sophie and Stuart, left the company prior to 7/1/2012. The remaining 15 NHCEs who were eligible on the date of failure will receive an amount based on the pro-rata share of their compensation. For example, assume Adam earned $45,000 and the total amount of compensation was $998,000. Adam's share of the allocation would be $45,000/$998,000 x $8,910.72 or $401.79.

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One-to-One Correction Method, Continued

Table – contributions of excess contributions

NHCE	Compensation	Elective Deferral Percentage	Elective Contribution	Allocation of Excess Contributions
Adam	$45,000	0%	$0.00	$401.79
Brenda	$55,000	2%	$1,100.00	$491.07
Christine	$60,000	2%	$1,200.00	$535.71
Debbie	$52,000	0%	$0.00	$464.29
Dick	$73,000	3%	$2,190.00	$651.79
Gwen	$58,000	2%	$1,160.00	$517.86
Harold	$47,000	0%	$0.00	$419.64
Harry	$82,000	4%	$3,280.00	$732.14
Jane	$77,000	4%	$3,080.00	$687.50
Leah	$59,000	3%	$1,770.00	$526.79
Mary	$66,000	0%	$0.00	$589.29
Max	$85,000	4%	$3,400.00	$758.93
Nancy	$92,000	4%	$3,680.00	$821.43
Steven	$85,000	1%	$850.00	$758.93
Tom	$62,000	2%	$1,240.00	$553.57
Total	$998,000			$8,910.72

Section .04 of Appendix A – Failure to Distribute Excess Deferrals under Section 402(g)

Correction Method

The correction method for failing to distribute excess deferrals under section 402(g) is to distribute the excess deferral to the employee and to report the amount as taxable in the year of deferral and in the year distributed. Including both the deferral and the distribution in gross income applies whether or not any portion of the deferral is attributable to a Roth contribution.
Amounts distributed to a HCE are included in the ADP test; amounts distributed to a NHCE are not.

Section .05(2) of Appendix A-Improperly Excluded Employees under Section 401(k) and 401(m)

General Rule

If an employee was not given the opportunity to elect and make elective deferrals to a section 401(k) plan (that is not a safe harbor plan under section 401(k)(12) or (13)), the employer must make a QNEC to the plan for the employee that replaces the "missed deferral opportunity."

Missed Deferral Opportunity

The missed deferral opportunity is equal to 50% of the employee's missed deferral.

Missed Deferral

The missed deferral is determined by multiplying the actual deferral percentage for the year of exclusion for the employee's group in the plan (either HCE or NHCE) by the employee's compensation for that year. This amount is reduced further to ensure that the missed deferral does not exceed applicable plan limits, including the limit under section 402(g) for the calendar year of the failure.

Earnings

The QNEC is adjusted for earnings to the date the corrective QNEC is made for the affected employee.

Example 6

A 401(k) plan improperly excludes an employee from making elective deferrals. Adam was not given the opportunity to elect and make elective deferrals. The plan uses the prior year method and is a calendar year plan. The testing year is 2010. Adam is a NHCE with compensation of $65,000 for 2010. Adam had compensation of $60,000 for 2009. The 2009 ADP for the NHCEs is 4%.

Calculating the Missed Deferral

The missed deferral is determined by multiplying the ADP in the prior year, 2009, by the compensation for that year. The missed deferral is 4% x $60,000 or $2,400. Remember, the NHCE ADP was 4% for 2009.

Calculating the Missed Deferral Opportunity

The missed deferral opportunity is 50% of the missed deferral, or 50% of $2,400, which is $1,200. This is the amount, plus earnings, that must be contributed to the plan.

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Calculating Earnings

Assume the date of correction is 8/1/2012. Since the plan is using the prior year method, the employee was not able to make elective deferrals for 2009. The earnings must be calculated from 12/31/2009, through 8/1/2012.

Plan cannot be Treated as Two Separate Plans or Restructured

Under this correction method, a plan may not be treated as two separate plans, one covering otherwise excludable employees and the other covering all other employees. In addition, restructuring the plan into component plans to reduce the applicable ADP, the corresponding missed deferral, and the required QNEC is not permitted.

Employee Eligible for Matching Contributions

If the employee was eligible but did not receive an allocation of employer matching contributions under a non-safe harbor plan because he or she was not given the opportunity to make elective deferrals, the employer would also have to make a QNEC for the employee.

The QNEC is equal to the matching contributions the employee would have received had the employee made a deferral equal to the missed deferral under section .05(2)(b). The missed deferral is determined by multiplying the ADP for the year of exclusion for the employee's group (either NHCEs or HCEs) by the employee's compensation for that year. The QNEC must be adjusted for earnings to the date the QNEC is made for the employee.

Example 7

Same facts as previous example, except that the plan has the following matching contribution formula:

- 100% on the first 2% of compensation,
- 75% on the next 1% of compensation,
- 50% on the next 2% of compensation.

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Calculating the Matching Contribution

The matching contribution is based on the missed deferral. Since the missed deferral is based on the NHCE ADP of 4%, the matching contribution is also based on this amount. Applying the formula up to 4%:

- 100% on the first 2% of compensation, or 2% x $60,000 or $1,200.
- 75% on the next 1% of compensation, which is .0075 x $60,000 or $450.
- 50% on the next 1% (which equals 4%) of compensation, which is .005 x $60,000 or $300.

The total QNEC is $1,950, which is the sum of $1,200 plus $450 plus $300.

Calculating Earnings

The earnings on the $1,950 must be calculated from 12/31/2009, through 8/1/2012. Section 6.02(4)(a) provides that corrective allocations under a defined contribution ("DC") plan should be adjusted for earnings and losses. However, a corrective allocation is not required to be adjusted for losses.

Correction for Excluded Employees under a Safe Harbor Plan – Matching Contributions

If an employee was not given the opportunity to elect to and make elective deferrals to a safe harbor 401(k) plan that uses matching contributions to satisfy the safe harbor requirements of section 401(k)(12), then the missed deferral is deemed equal to the greater of:

- 3% of compensation or
- the maximum deferral percentage for which the employer provides a 100% matching contribution rate of the elective deferral made by the employee,

In other words, the missed deferral is equal to the greatest deferral percentage at which the employee would receive a 100% match. This estimate of the missed deferral replaces the estimate based on the ADP test in a traditional 401(k) plan.

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Section .05(2) of Appendix A-Improperly Excluded Employees under Section 401(k) and 401(m), Continued

Required QNEC	The required QNEC for the excluded employee is equal to 50% of the missed deferral plus matching contributions that would apply based on the missed deferral.
Correction for Excluded Employees under a Safe Harbor Plan-Nonelective Contributions	If an employee was not given the opportunity to elect and make elective deferrals to a safe harbor section 401(k) plan that uses nonelective contributions to satisfy the safe harbor requirements of section 401(k)(12), then the missed deferral is deemed equal to 3% of compensation. The required QNEC for the excluded employee is equal to 50% of the missed deferral plus the nonelective contribution required to be made for the employee.
Earnings	The required QNECs, corresponding matching contributions, and nonelective contributions are adjusted for earnings to the date the corrective QNEC is made for the affected employee.

Section .05(3) - Improperly Excluded Employees-Designated Roth Contributions and Other Rules for Roth Contributions

General Rule

For employees who were improperly excluded from plans subject to 401(k) and provide for optional treatment of elective deferrals as designated Roth contributions, the correction is the same as per section .05(2). For example, the corrective employer contribution required to replace the missed deferral opportunity is made per section .05(2)(b).

Under this method, the employer must make a qualified nonelective contribution that replaces the missed deferral opportunity, which is equal to 50% of the employee's missed deferral.

None of the corrective contributions may be treated as designated Roth contributions, and may not be included in an employee's gross income. The corrective contribution must be allocated to an account established to receive a qualified nonelective contribution and any other employer contribution in which the employee is fully vested and is subject to the withdrawal restrictions that apply to elective deferrals.

Section .05(5) (see below)

The correction method for failure to implement an employee's elections for elective deferrals also includes designated Roth contributions. Other correction methods also include designated Roth contributions, see Appendix B, Section 2.02, including expansion of correction method to partial year exclusion, elective deferral failures and matching contribution failures.

Appendix B, Section 2.01(b)(iv)(B)(3)

The examples in Appendix B generally do not identify whether the plan offers designated Roth contributions. The results in the examples, including corrective contributions, would be the same whether or not the plan offered designated Roth contributions.

Section .05(4)(a) of Appendix A -Correction for Missed Catch-Up Contributions

50% QNEC

If an eligible employee was not given the opportunity to elect and make catch-up contributions to a section 401(k) plan, the employer must make a QNEC to the plan for the employee to replace the "missed deferral opportunity" attributable to the failure to permit an eligible employee to make a catch-up contribution under to section 414(v).

Missed Deferral Opportunity

The missed deferral opportunity for catch-up contributions is 50% of the employee's missed deferral attributable to catch-up contributions. Here, the missed deferral attributable to catch-up contributions is one-half of the applicable catch-up contribution limit for the year in which the employee was improperly excluded.

Adjusted for Earnings

The QNEC required for the year of exclusion is adjusted for earnings to the date the corrective QNEC is made for the affected employee.

Eligible Employee

For this correction, an eligible employee, under §414(v)(5), means any participant who:

(i) would have attained age 50 by the end of the plan's taxable year and

(ii) in the absence of the plan's catch-up provision, could not make additional elective deferrals because of the plan or statutory limitations per §414(v)(3) and §1.414(v)-1(b)(1).

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Section .05(4)(a) of Appendix A -Correction for Missed Catch-Up Contributions, Continued

Example 8

If an eligible employee was improperly excluded from electing and making catch-up contributions in 2012, the missed deferral attributable to catch-up contributions is one half of $5,500, the 2012 catch-up contribution limit for a section 401(k) plan, or $2,750.

The eligible employee's missed deferral opportunity is $1,375 (i.e., 50% of the missed deferral attributable to catch-up contributions of $2,750).

Code Sections

Related Code sections: §414(v), §414(v)(3), §1.414(v)-1(b)(1) and §414(v)(5).

Pre-tax 401(k) Catch-up Limits

The Catch-Up limits are:

- 2008 - $5,000
- 2009 - $5,500
- 2010 - $5,500
- 2011 - $5,500
- 2012 - $5,500
- 2013 - $5,500 plus an index for inflation ($500 increments)

Section .05(b), Correction for Missed Matching Contributions

Plan Sponsor should Determine Affected Employees

If an employee missed the opportunity to make catch-up contributions, the plan sponsor should determine if the affected employee would have been entitled to an additional matching contribution because of the missed deferral.

QNEC for Missed Matching Contributions

If the employee would have been entitled to receive an additional matching contribution, then the employer must make a QNEC for the matching contribution for the affected employee.

Calculating QNEC

The QNEC is equal to the additional matching contribution the employee would have received had the employee made the deferral per Rev. Proc. 2008-50, Section .05(4)(a) (the catch up contribution). The QNEC is adjusted for earnings to the date the contribution is made.

If Plan Failed the ACP Test

If, in addition to the failure to provide matching contributions under Rev. Proc. 2008-50, Section .05(4)(b), the plan also failed the ACP test, the correction methods cannot be used until **after** correction of the ACP test.

Determining if the Plan Passed the ACP Test

To determine if the plan passed the ACP test, the plan may rely on a test performed for those eligible employees who had the opportunity to make elective deferrals or after-tax employee contributions and received an allocation of employer matching contributions.

The employer may disregard any employer matching contribution that was not made because of the plan's failure to provide an eligible employee with the opportunity to make a catch up contribution.

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Section .05(b), Correction for Missed Matching Contributions,
Continued

Example 9

A plan provides for catch-up contributions and for a 60% match on elective deferrals. The deferral limit under section 402(g) for 2010 is $16,500. The limit on catch-up contributions is $5,500.

An employee was provided with the opportunity to make elective deferrals up to the plan's limit, but was not given the opportunity to make catch-up contributions. The employee, a NHCE, had 2010 compensation of $90,000 and made elective deferrals of $16,500.

Section .05(4) of Appendix A provides that the employee's missed deferral because of the plan's failure to offer that employee the opportunity to make catch-up contributions is $2,750, which is one half of the catch-up limitation of $5,500. The missed deferral opportunity is 50% of the missed deferral, or $1,375 requiring a QNEC of $1375.

The employer is also entitled to an additional matching contribution, which is equal to 60% of the missed deferral attributable to the catch-up contribution that the employee would have made if the failure did not occur. The additional matching contribution is $1650, which is 60% of the catch-up contribution limitation of $2,750. The total QNEC would be $1,375 plus $1,650 or $3,025, with earnings.

Section .05(5)(a)-Failure to Implement an Employee Election

Failure to Implement Election	For eligible employees who filed elections to make elective deferrals under the plan that the plan sponsor failed to timely implement, the plan sponsor must make a QNEC for the employee to replace the "missed deferral opportunity."
Missed Deferral Opportunity	The missed deferral opportunity is **50%** of the employee's "missed deferral."
Calculating the Missed Deferral	The missed deferral is determined by multiplying the employee's elected deferral percentage by the employee's compensation. If the employee elected a dollar amount for an elective deferral, the missed deferral would be that specified dollar amount. The employee's missed deferral amount is reduced further to the extent necessary to ensure that the missed deferral does not exceed applicable plan limits, including the annual deferral limit under §402(g) for the calendar year of the failure.

Section .05(5)(b), Missed Opportunity for after-Tax Employee Contributions

QNEC to Replace Employee's Missed Opportunity

For eligible employees who filed elections to make after-tax employee contributions under the plan, which the plan sponsor failed to timely implement, the plan sponsor must make a QNEC to the plan for the employee to replace the missed opportunity for after-tax employee contributions.

Missed Opportunity for Making after Tax Contributions

The missed opportunity for making after-tax employee contributions is **40%** of the employee's "missed after-tax contributions."

The missed after-tax employee contribution is determined by multiplying the employee's elected after-tax employee contribution percentage by the employee's compensation.

Example 10

Leah Company sponsors a section 401(k) plan which permits after-tax employee contributions. Adam earns $85,000 for the 2010 tax year. Adam elected to make after-tax contributions of 6% of compensation which Leah Company failed to implement.

Leah Company must make a QNEC equal to Adam's missed opportunity for after-tax contributions. This missed opportunity is 40% of the missed after-tax contributions, determined by Adam's after-tax contribution percentage of 6% multiplied by his compensation of $85,000, making Adam's missed after-tax contribution $5,100. The missed opportunity for making after-tax employee contributions is 40% of $5,100 or $2,040 which is the amount of the QNEC that must be made to the plan.

Section .05(5)(c)-Matching Contributions

Matching Contributions

In a failure to implement an employee election, if the employee would have been entitled to an additional matching contribution had either the missed deferral or after-tax employee contribution been made, then the employer must make a QNEC for the matching contribution.

The QNEC is equal to the matching contribution the employee would have received had the employee made a deferral equal to the missed deferral and must be adjusted for earnings to the date the corrective QNEC is made.

Example 11

Same facts as the previous example, except that the plan provides matching contributions of 50% on after-tax contributions.

Leah Company must make an additional QNEC equal to the matching contribution that Adam would have received if he had been able to make the deferral of 6% of his compensation of $85,000. His missed deferral is $5,100 and the QNEC for missed matching contributions is $2,550.

Section .05(5)(d)-Coordination with Correction of Other Qualified Failures

Timing of Corrections

The method for correcting the failures per Rev. Proc. 2008-50, Section .05(5) does not apply until **after** the correction of other qualification failures.

For example, if, in addition to the failure to implement an employee's election, the plan also failed the ADP test or ACP test, the correction methods in Appendix A, Section .05(5)(a), (b) or (c) cannot be used until **after** correction of the ADP or ACP test failures.

To determine whether the plan passed the ADP or ACP test, the plan may rely on a test performed for those eligible employees not impacted by the plan sponsor's failure to implement employee elections and who received allocations of employer matching contributions. The plan may disregard employees whose elections were not properly implemented.

Example of Multiple Failures

Example 12-Facts

Same facts as Example 3 used above. You are examining a section 401(k) plan and discover the calendar year basis plan failed the ADP test in 2010. Corrections were not made by 12/31/2011. The employer decides to contribute QNECs under Rev. Proc. 2008-50 using the one-to-one method. The employer has two HCEs and 17 NHCEs. The HCE ADP was 7% and the NHCE ADP was 1.94%.

The plan has the following matching formula:

- 100% up to the first 2% of compensation, and
- 50% for the next 5% of compensation.

The current year method is used for ADP/ACP testing. Interest is calculated from the date of the failure (12/31/2011) through the date of correction (assume 7/2/2012). Also assume a 4% rate of return on plan assets for 2012. The adjustment for earnings for 1/2 of the year is 2%.

The table below shows the elective deferrals for 17 NHCEs, with a NHCE ADP of 1.94%.

Other Failures

You also discover that the employer incorrectly excluded 5 employees from making elective deferrals and receiving matching contributions.

Finally, you discover that the employer failed to implement employee elections for 3 employees. Additional QNECs are required for both the failure of incorrectly excluding employees and the failure to implement the elections.

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Summary of Defects

Three main operational defects that must be corrected through Rev. Proc. 2008 – 50 are:

- failure of the ADP/ACP test,
- incorrectly excluding five employees from making elective deferrals and receiving matching contributions,
- failing to timely implement elective deferrals and matching contributions for three employees.

Disregarding Improperly Excluded Employees

Appendix A, Section .05(2)(g) provides that incorrectly excluding employees from a 401(k)/(m) plan cannot be corrected until after the other qualification failures are corrected. For example, if the plan also failed the ADP/ACP test, the correction method for excluding employees cannot be used until the ADP/ACP failures are corrected.

Section .05(2)(g) also states that, when running the ADP/ACP test and correcting the ADP/ACP failure, the employer may disregard the improperly excluded employees.

Failing to Implement Elective Deferrals

Section .05(5)(d) of Appendix A provides that the correction for failing to timely implement the elective deferrals cannot be made until after the correction of other qualification failures. If the plan also failed the ADP/ACP test, that correction must be made before correcting the defect for failing to implement elective deferrals.

Again, the employer may also run the ADP/ACP test and disregard the employees affected by the employer's failure to implement the employee elective deferrals.

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Example of Multiple Failures, Continued

Order of Correction

Based on Sections .05(2)(g) and .05(5)(d), the ADP/ACP failures in this example must be corrected before the correction of the other failures:

- improperly excluding five employees, and
- failing to implement the elective deferrals of three employees.

Example-ADP Test Correction

Table Below This table shows both the NHCEs and HCEs elective deferral percentage and the elective contributions.

Table I-NHCEs – 2010

	Compensation	Elective Deferral Percentage	Elective Contribution
Adam	$45,000	0%	$0.00
Brenda	$55,000	2%	$1,100.00
Christine	$60,000	2%	$1,200.00
Debbie	$52,000	0%	$0.00
Dick	$73,000	3%	$2,190.00
Gwen	$58,000	2%	$1,160.00
Harold	$47,000	0%	$0.00
Harry	$82,000	4%	$3,280.00
Jane	$77,000	4%	$3,080.00
Leah	$59,000	3%	$1,770.00
Mary	$66,000	0%	$0.00
Max	$85,000	4%	$3,400.00
Nancy	$92,000	4%	$3,680.00
Sophie	$94,000	2%	$1,880.00
Steven	$85,000	1%	$850.00
Stuart	$68,000	0%	$0.00
Tom	$62,000	2%	$1,240.00
Total		33.00%	$24,830.00
Average		**1.94%**	

Table II – HCEs – 2010

HCEs	Compensation	Elective Deferral Percentage	Elective Contribution
Jed	$130,000	7%	$9,100.00
Seymour	$150,000	7%	$10,500.00
Average		**7%**	

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ADP Test

There are two prongs to the ADP test and the HCE ADP must be less than or equal to the greater of:

- 125% of the NHCE ADP, or
- the lesser of 2+ or 2x the NHCE ADP.

The NHCE ADP as calculated in table I is 1.94%. Applying the ADP test, the HCE ADP cannot be greater than:

- 1.94% x 1.25% or 2.43% or
- the lesser of 2+1.94% (3.94%) or 2x 1.94% (3.88%) or 3.88%.

Since the HCE ADP of 7% is greater than 3.88%, the plan fails the ADP test.

The Excluded Employees not Considered

Remember, there are eight employees who are not considered when running the ADP test. There were five employees improperly excluded from the plan and three employees for whom the employer did not implement their elective deferral elections.

The corrections for these eight employees will be made after the ADP/ACP correction.

One-to-One Method

If a plan fails the ADP/ACP test and the plan is not timely corrected, Rev. Proc. 2008-50 permits the one-to-one correction method. Under this method, excess contributions are determined and assigned to HCEs. The excess contributions, with earnings, are either distributed to the HCEs or forfeited from the HCEs' accounts.

The same excess contribution amounts, with earnings, are contributed to the plan and allocated to NHCEs. The contribution must satisfy the vesting requirements and distribution limitations of section 401(k)(2)(B) and (C).

See section 2.01(b)(iv)(A) of Appendix B

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Determining the Excess Contribution Amount

The excess contribution amount (not to be confused with terms for ACP failures) is equal to the excess of:

- the sum of excess contributions per section 401(k)(8)(B)(i), and excess aggregate contributions per section 401(m)(6)(B)(i), over
- previous corrections that complied with 401(k)(8) and section 401(m)(6)(ii).

If there were no corrections for a plan year, the excess contribution amount is equal to the sum of the excess contributions or the sum of the excess aggregate contributions.

Calculating the Excess Contributions

To calculate the excess contributions, the plan must use the percentage leveling method. The NHCE ADP is 1.94%. The maximum HCE ADP that allows the plan to pass the ADP test must be equal to 3.88%.

To determine the excess contributions, the HCE ADP has to be reduced from 7% to 3.88% using the percentage leveling method. Since both Jed and Seymour have a 7% elective deferral percentage, their percentages are reduced equally until their elective deferral percentages equal 3.88%.

The excess contribution percentage of 3.12% is applied to both Jed's and Seymour's salaries.

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Example-ADP Test Correction, Continued

Total Excess Contributions

The excess contributions total $8,736, calculated as:

HCEs	Compensation	Elective deferral percentage	Elective contribution	Reduction percentage	Excess contribution
Jed	$130,000	7%	$9,100	3.12%	$4,056.00
Seymour	$150,000	7%	$10,500	3.12%	$4,680.00
Total					$8,736.00

Explanation of Table

The reduction percentage of 3.12% is multiplied by Jed's and Seymour's compensation to calculate their excess contributions. The sum of these excess contributions is $8,736.

Dollar Leveling Method

Once the total excess contributions have been determined, the dollar leveling method is used to determine how much should be returned to each HCE, as shown below. Earnings are calculated from the date of the failure (12/31/2011) through the date of correction (assuming 7/1/2012).

Seymour had $10,500 and Jed had $9,100 in elective contributions. Under the dollar leveling method, the HCE with the highest dollar amount of elective contributions is corrected first. Seymour receives $1,400 of elective contributions before Jed receives any elective contributions. Seymour's level of elective contributions is reduced from $10,500 to $9,100. Since the $1,400 does not exhaust the excess contributions, the remaining contributions of $7,336 are divided equally between Jed and Seymour. Jed receives $3,668 of excess contributions and $5,068 is returned to Seymour.

	Elective Contribution	Excess Contribution determined under the % method	Dollar Leveling	Remaining Elective Contributions	Balance of Excess Contributions	Dollar Leveling	Remaining Elective Contributions	**Total Excess contrib.**	Earnings
Jed	$9,100	$4,056	$0	$9,100		$3,668	$5,432	**$3,668**	$73.36
Seymour	$10,500	$4,680	$1,400	$9,100		$3,668	$5,432	**$5,068**	$101.36
Total	$19,600	$8,736	$1,400		$7,336	$7,336	$10,864	**$8,736**	$174.72

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Example-ADP Test Correction, Continued

Contribution and Allocation

The employer chooses to contribute these excess contributions to the eligible NHCEs employed on the correction date, 7/1/2012. Two employees who were eligible for the contribution, Sophie and Stuart, left the company prior to 7/1/2012. The remaining 15 NHCEs who were eligible on the date of failure will receive an amount based on the pro-rata share of their compensation. For example, assume Adam earned $45,000 and the total amount of compensation was $998,000. Adam's share of the allocation would be $45,000/$998,000 x $8,910.72 or $401.79.

Table – contributions of excess contributions

NHCE	Compensation	Elective Deferral Percentage	Elective Contribution	Allocation of Excess Contributions
Adam	$45,000	0%	$0.00	$401.79
Brenda	$55,000	2%	$1,100.00	$491.07
Christine	$60,000	2%	$1,200.00	$535.71
Debbie	$52,000	0%	$0.00	$464.29
Dick	$73,000	3%	$2,190.00	$651.79
Gwen	$58,000	2%	$1,160.00	$517.86
Harold	$47,000	0%	$0.00	$419.64
Harry	$82,000	4%	$3,280.00	$732.14
Jane	$77,000	4%	$3,080.00	$687.50
Leah	$59,000	3%	$1,770.00	$526.79
Mary	$66,000	0%	$0.00	$589.29
Max	$85,000	4%	$3,400.00	$758.93
Nancy	$92,000	4%	$3,680.00	$821.43
Steven	$85,000	1%	$850.00	$758.93
Tom	$62,000	2%	$1,240.00	$553.57
Total	$998,000			$8,910.72

Example-ACP Test Correction

Introduction

Since the plan failed the ACP test, that correction must be made before the other defects can be corrected.

Matching Contribution Formula

The plan provides a matching contribution formula:

- 100% up to the first 2% of compensation,
- 50% for the next 5% of compensation.

Table I-Matching Contributions

	Compensation	Elective Deferral Percentage	Elective Contribution	Matching Contribution Percentage	Matching Contributions
Adam	$45,000	0%	$0.00	0.00%	$0.00
Brenda	$55,000	2%	$1,100.00	2.00%	$1,100.00
Christine	$60,000	2%	$1,200.00	2.00%	$1,200.00
Debbie	$52,000	0%	$0.00	0.00%	$0.00
Dick	$73,000	3%	$2,190.00	2.50%	$1,825.00
Gwen	$58,000	2%	$1,160.00	2.00%	$1,160.00
Harold	$47,000	0%	$0.00	0.00%	$0.00
Harry	$82,000	4%	$3,280.00	3.00%	$2,460.00
Jane	$77,000	4%	$3,080.00	3.00%	$2,310.00
Leah	$59,000	3%	$1,770.00	2.50%	$1,475.00
Mary	$66,000	0%	$0.00	0.00%	$0.00
Max	$85,000	4%	$3,400.00	3.00%	$2,550.00
Nancy	$92,000	4%	$3,680.00	3.00%	$2,760.00
Sophie	$94,000	2%	$1,880.00	2.00%	$1,880.00
Steven	$85,000	1%	$850.00	1.00%	$850.00
Stuart	$68,000	0%	$0.00	0.00%	$0.00
Tom	$62,000	2%	$1,240.00	2.00%	$1,240.00
Total		33.00%	$24,830.00	28.00%	$20,810.00
Average		**1.94%**		**1.65%**	

Jed	$130,000	7%	$9,100.00	4.50%	$5,850.00
Seymour	$150,000	7%	$10,500.00	4.50%	$6,750.00
Average		**7%**		**4.50%**	

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Example-ACP Test Correction, Continued

Applying the ACP Test

The ACP test is the same as the ADP test; the HCE ACP has to be equal to the greater of two prongs:

- 125% of the NHCE ACP or
- the lesser of 2x the NHCE ACP or 2+ the NHCE ACP.

The HCE ACP cannot be higher than the greater of:

- 125% of 1.65% or **2.06%,**
- the lesser of 2x 1.65% (3.30%) or 2+1.65% (3.65%)--**3.3%.**

Plan Fails the ACP Test

The plan fails the ACP test because the HCE ACP of 4.5% is greater than 3.3%.

Calculating the Excess Aggregate Contributions

The plan must use the percentage leveling method to calculate excess aggregate contributions. Since both Jed's and Seymour's contributions have a 4.5% matching contribution percentage, those percentages are reduced equally until their matching contribution percentages equal 3.3%.

The excess aggregate contribution percentage is 1.2%, which is applied to both Jed's and Seymour's salary, $130,000 x 1.2%=$1,560 and $150,000 x 1.2% = $1,800.

HCEs	Matching contribution	Excess aggregate contributions	Dollar leveling	Remaining matching contributions	Balance of excess aggregate contributions	Dollar leveling	Remaining matching contributions	Total returned	Earnings	Total
Jed	$5,850	$1,560	$0	$5,850		$1,230	$4,620	$1,230	$24.60	$1,254.60
Seymour	$6,750	$1,800	$900	$5,850		$1,230	$4,620	$2,130	$42.60	$2,172.60
Total	$12,600	$3,360	$900	$11,700	$2,460	$2,460	$9,240	$3,360	$67.20	$3,427.20

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Explanation of Table	Since the reduction to both Jed's and Seymour's matching contribution percentages was 1.2%, this percentage is multiplied by their compensation to calculate their excess aggregate contribution. The total excess aggregate contribution is $3,360, which is the sum of Jed's excess aggregate contribution of $1,560, and Seymour's excess aggregate contribution of $1,800.
Dollar Leveling Method	Once the total excess aggregate contributions are determined, the dollar leveling method is used to determine the amount of excess aggregate contributions to be returned to each HCE, which is shown in the table above. There are also earnings calculated from the date of the failure (12/31/2011 through the date of correction, assuming 7/1/2012)
Explanation of Table	In the table above, Jed has matching contributions of $5,850 and Seymour has matching contributions of $6,750. Under the dollar leveling method, the ADR of the HCE with the highest dollar amount of matching contributions is corrected first. Seymour's matching contribution of $6,750 is reduced to the next level of matching contributions, or $5,850. Seymour receives $900 before Jed receives any distribution of matching contributions. Since $900 does not eliminate all the excess contributions of $3,360, the dollar leveling method is used again. In this case, since both Jed and Seymour have matching contributions of $5,850 remaining, these matching contributions are reduced equally until the excess aggregate contributions are exhausted. The remaining amount of $2,460 is divided by two and is apportioned to both Jed and Seymour. With this step, Jed and Seymour will each receive $1,230. Since Seymour will already receive $900, he will receive a total of $2,130 ($900 plus $1,230). Jed will receive $1,230.
Earnings on Excess Aggregate Contributions	The date of correction is assumed to be7/1/2012 and the rate of earnings from the date of failure to the date of correction is 2%. Per the table above, the earnings on Seymour's excess aggregate contributions are $42.60, and the earnings on Jed's excess aggregate contributions are $24.60.

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Contribution and Allocation

The total contribution required under the one-to-one correction method is $3,427.20, including earnings of $67.20.

The employer chooses to contribute the excess aggregate contributions to the eligible NHCEs who are employed on the correction date, 7/1/2012. Two employees who were eligible for the contribution, Sophie and Stuart, left the company prior to 7/1/2012. The remaining 15 NHCEs who were eligible on the date of failure will receive an allocation based on a pro-rata share of their compensation.

For example, assume Adam earned $45,000 and the total amount of compensation was $998,000. Adam's share of the allocation would be $45,000/$998,000 x $3,427.20 or $154.53.

NHCE	Compensation	Elective Deferral Percentage	Matching Contribution Percentage	Matching Contributions	One-to-one allocation	Total Contribution
Adam	$45,000	0%	0.00%	$0.00	$154.53	$154.53
Brenda	$55,000	2%	2.00%	$1,100.00	$188.87	$1,288.87
Christine	$60,000	2%	2.00%	$1,200.00	$206.04	$1,406.04
Debbie	$52,000	0%	0.00%	$0.00	$178.57	$178.57
Dick	$73,000	3%	2.50%	$1,825.00	$250.69	$2,075.69
Gwen	$58,000	2%	2.00%	$1,160.00	$199.18	$1,359.18
Harold	$47,000	0%	0.00%	$0.00	$161.40	$161.40
Harry	$82,000	4%	3.00%	$2,460.00	$281.59	$2,741.59
Jane	$77,000	4%	3.00%	$2,310.00	$264.42	$2,574.42
Leah	$59,000	3%	2.50%	$1,475.00	$202.61	$1,677.61
Mary	$66,000	0%	0.00%	$0.00	$226.65	$226.65
Max	$85,000	4%	3.00%	$2,550.00	$291.90	$2,841.90
Nancy	$92,000	4%	3.00%	$2,760.00	$315.93	$3,075.93
Steven	$85,000	1%	1.00%	$850.00	$291.90	$1,141.90
Tom	$62,000	2%	2.00%	$1,240.00	$212.91	$1,452.91
Total	$998,000				$3,427.20	

Example-Improperly Excluded Employees

Introduction

Now that the ADP/ACP tests are completed and the defects have been corrected, the employer can correct the other 2 defects:

- improperly excluding 5 employees from the 401(k) and (m) plan,
- failing to properly implement the elective deferral election for 3 employees.

The employer improperly excluded 5 employees. The employee information is in the table below:

Employees incorrectly excluded	
Employee	2010 Compensation
Armond	$38,000
Christopher	$45,000
Jennifer	$52,000
Judy	$60,000
Pete	$75,000

Correction

If an employer improperly excluded an employee from a 401(k) and/or (m) plan, the employer must make a QNEC for that employee which replaces the missed deferral opportunity. The missed deferral opportunity is 50% of the employee's missed deferral. The QNEC is adjusted for earnings to the date of correction.

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Example-Improperly Excluded Employees, Continued

Missed Deferral

The missed deferral is determined by multiplying the ADP in the year of exclusion for the employee's group (either NHCE or HCE) by the employee's compensation for that year.

This table illustrates the missed deferral opportunity, with earnings of 2% calculated from 12/31/2011 through 7/1/2012.

Employees incorrectly excluded						
Employee	2010 Comp.	ADP for NHCEs	Missed deferral	Missed deferral opportunity	Earnings	Total QNEC
Armond	$38,000	1.94%	$737.20	$368.60	$7.37	$375.97
Christopher	$45,000	1.94%	$873.00	$436.50	$8.73	$445.23
Jennifer	$52,000	1.94%	$1,008.80	$504.40	$10.09	$514.49
Judy	$60,000	1.94%	$1,164.00	$582.00	$11.64	$593.64
Pete	$75,000	1.94%	$1,455.00	$727.50	$14.55	$742.05
Total			$5,238.00	$2,619.00	$52.38	$2,671.38

Explanation of Table

This table shows the missed deferral. The NHCE ADP of 1.94% is multiplied by the excluded employees' compensation. The missed deferral opportunity is determined by multiplying the missed deferral by 50%. Earnings were calculated by multiplying the missed deferral opportunity by 2%.

Matching Contributions

If the employee did not receive matching contributions because the employee was not given the opportunity to make elective deferrals, the employer should make a QNEC for the affected employee.

The QNEC is equal to the matching contribution the employee would have received had the employee made a deferral equal to the missed deferral. The missed deferral is calculated by multiplying the ADP of the NHCEs by the employees' compensation. See table above.

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Example-Improperly Excluded Employees, Continued

Matching Contribution Rate

The plan has the following matching formula:

- 100% up to the first 2% of compensation,
- 50% for the next 5% of compensation.

Since the missed deferral is based on the NHCE ADP of 1.94%, the excluded employee would have received a 100% match. The required QNEC would be 1.94% multiplied by the excluded employee's compensation. See the table below:

Employees incorrectly excluded-match calculation						
Employee	2010 Compensation	ADP for NHCEs	Missed Deferral	Match at 100%	Earnings	Total QNEC
Armond	$38,000	1.94%	$737.20	$737.20	$14.74	$751.94
Christopher	$45,000	1.94%	$873.00	$873.00	$17.46	$890.46
Jennifer	$52,000	1.94%	$1,008.80	$1,008.80	$20.18	$1,028.98
Judy	$60,000	1.94%	$1,164.00	$1,164.00	$23.28	$1,187.28
Pete	$75,000	1.94%	$1,455.00	$1,455.00	$29.10	$1,484.10
Total			$5,238.00	$5,238.00	$104.76	$5,342.76

Total QNEC

The total QNEC for both the missed deferral and the match is provided below:

Employee incorrectly excluded-total QNEC					
Employee	2010 Compensation	ADP for NHCEs	Total QNEC for Elective Deferral	Total QNEC for Match	Total QNEC
Armond	$38,000	1.94%	$375.97	$751.94	$1,127.92
Christopher	$45,000	1.94%	$445.23	$890.46	$1,335.69
Jennifer	$52,000	1.94%	$514.49	$1,028.98	$1,543.46
Judy	$60,000	1.94%	$593.64	$1,187.28	$1,780.92
Pete	$75,000	1.94%	$742.05	$1,484.10	$2,226.15
Total			$2,671.38	$5,342.76	$8,014.14

Example-did not properly Implement Employees' Deferral Elections

Facts

There were three employees for whom the employer did not implement their deferral election:

Failure to implement election		
Employee	2010 Compensation	Elective Deferral Percentage
David	$82,000	5%
Sarah	$58,000	3%
Tim	$45,000	2%

Correction

The employer must make a QNEC for those employees for whom the employer failed to timely implement their elective deferrals. The QNEC is the missed deferral opportunity--50% of the missed deferral.

Missed Deferral

A missed deferral is determined by multiplying the employee's elected deferral percentage by the employee's compensation. This table shows the QNEC for those employees for whom the employer did not implement their deferral elections:

Failure to implement election						
Employee	2010 Compensation	Elective deferral percentage	Missed deferral	Missed deferral opportunity	Earnings	Total QNEC
David	$82,000	5%	$4,100.00	$2,050.00	$41.00	$2,091.00
Sarah	$58,000	3%	$1,740.00	$870.00	$17.40	$887.40
Tim	$45,000	2%	$900.00	$450.00	$9.00	$459.00
						$3,437.40

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Example-did not properly Implement Employees' Deferral Elections, Continued

Explanation of Table

The three employees in the table above made an election to contribute elective deferrals to the 401(k) plan. The missed deferral is calculated by multiplying each employee's elective deferral percentage by the employee's compensation. The missed deferral opportunity is calculated by multiplying the missed deferral by 50%. The earnings are calculated by multiplying the missed deferral opportunity by 2%.

Matching Contributions

If the employee would have been entitled to additional matching contributions had the missed deferral been made, the employer must make a QNEC for the matching contributions.

The QNEC is equal to the matching contribution the employee would have received had the employee made a deferral equal to the missed deferral. The QNEC is adjusted for earnings to the date of correction.

The Plan's Matching Formula

The plan has the following matching formula:

- 100% up to the first 2% of compensation, and
- 50% for the next 5% of compensation.

David's Matching Contributions

Since David had a missed deferral of 5% of compensation, his matching contribution would have been:

100% of the first 2% of compensation, which is 100% x 2% x $82,000 or $1,640.

50% on the next 3% of compensation, which is 50% x 3% x $82,000 or $1,230.

The total matching contribution that David would have received is $2,870.

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Example-did not properly Implement Employees' Deferral Elections, Continued

Sarah's Matching Contribution

Since Sarah had a missed deferral of 3% of compensation, her matching contribution would have been:

- 100% of the first 2% of compensation, which is 100% x 2% x $58,000 or $1,160.
- 50% on the next 1% of compensation, which is 50% x 1% x $58,000, which is $290.

The total matching contribution that Sarah would have received is $1,450.

Tim's Matching Contribution

Since Tim had a missed deferral of 2% of compensation, his matching contribution would have been:

- 100% on the first 2% of compensation, which is 100% x 2% x $45,000, or $900. The total matching contribution that Tim would have received is $900.

See table below:

Failure to Implement Election-Matching Contribution						
Employee	2010 Compensation	Elective deferral percentage	Missed deferral	Missed matching	Earnings	Total QNEC
David	$82,000	5%	$4,100.00	$2,870.00	$57.40	$2,927.40
Sarah	$58,000	3%	$1,740.00	$1,450.00	$29.00	$1,479.00
Tim	$45,000	2%	$900.00	$900.00	$18.00	$918.00
Total				$5,220.00	$104.40	$5,324.40

Total QNEC

The employer would have to contribute $5,324.40 for the matching contributions because of the failure to implement the deferral elections for David, Sarah, and Tim.

Summary

Important Points of Chapter

- If the plan sponsor fails to timely correct for the ADP/ACP test, the plan sponsor can correct the ADP/ACP test under one of the correction methods under EPCRS.
- There are two correction methods under EPCRS to satisfy the ADP/ACP test under EPCRS, QNECs or the one-to-one correction method.
- With the one-to-one correction method, excess contributions are distributed and the same amount is contributed to the plan and allocated to NHCEs.
- For improperly excluded employees, the employer must make a QNEC that replaces the missed deferral opportunity, which is 50% of the employee's missed deferral.
- The missed deferral is calculated by multiplying the ADP by the employee's compensation for that year.
- The correction for missed catch-up contributions is 50% of the employee's missed deferral, which is one-half of the applicable catch-up contribution for the year in which the employee was improperly excluded.
- For missed matching contributions, the employer must make a QNEC for the matching contribution for the affected employee.
- For failing to implement an employee election, the employer must make a QNEC equal to 50% of the employee's missed deferral, which is determined by multiplying the employee's elected deferral percentage by the employee's compensation.
- If the plan has more than one operational defect, the qualification failures, such as the ADP/ACP tests, have to be corrected before the correction of other defects.