

# 401(k) Plan Checklist

This checklist is *not* a complete description of all plan requirements, and should *not* be used as a substitute for a complete plan review.

Every year it is important that you review the requirements for operating your 401(k) retirement plan. Use this checklist to help you keep your plan in compliance with many of the important rules. Click on “(More)” in any of the following questions for additional information (including examples) on how to find, fix, and avoid each mistake. See [www.irs.gov/ep](http://www.irs.gov/ep) for online versions of the checklists, Fix-It Guides, and other resources for 401(k) and other plan types.

## For Business Owner’s Use

(DO NOT SEND THIS WORKSHEET TO THE IRS)

**1. Has your plan document been updated within the past few years?** Yes No

If your plan has not been updated to reflect recent law changes, the plan needs to be revised.

[\(More\)](#)

**2. Are the plan’s operations based on the terms of the plan document?** Yes No

Failure to follow the terms of the plan is a common problem encountered on audit.

[\(More\)](#)

**3. Is the plan’s definition of compensation for all deferrals and allocations used correctly?** Yes No

Because your plan may use different definitions of compensation for different purposes, it’s important that you apply the proper definition according to your plan document.

[\(More\)](#)

**4. Were employer matching contributions made to all appropriate employees under the terms of the plan?** Yes No

The terms of the plan must be followed when allocating employer matching contributions.

[\(More\)](#)

**5. Has the plan satisfied the 401(k) nondiscrimination tests (ADP and ACP)?** Yes No

Every 401(k) plan must satisfy yearly ADP/ACP nondiscrimination tests except for certain auto enrollment and 401(k) safe harbor plans.

[\(More\)](#)

**6. Were all eligible employees identified and given the opportunity to make an elective deferral election?** Yes No

By supplying your tax advisor with information regarding all employees who receive a Form W-2, you may reduce the risk of omitting eligible employees.

[\(More\)](#)

**7. Are elective deferrals limited to the amounts under IRC §402(g) for the calendar year?** Yes No

Failure to distribute deferrals in excess of the 402(g) limit may result in additional taxes and penalties to the participant and employer.

[\(More\)](#)

**8. Have you timely deposited employee elective deferrals?** Yes No

You should deposit deferrals as soon as they can be segregated from the employer’s assets.

[\(More\)](#)

**9. Do participant loans conform to the requirements of the plan document and IRC §72(p)?** Yes No

Defaulted loans or loans in violation of IRC §72(p) may be treated as a taxable distribution to the participant.

[\(More\)](#)

**10. Were hardship distributions made properly?** Yes No

If a plan allows hardship distributions, the terms of the plan must be followed.

[\(More\)](#)

**If you answered “No” to any of the above questions, you may have made a mistake in the operation of your 401(k) plan. This list is only a guide to a more compliant plan, so answering “Yes” to each question may not mean your plan is 100% compliant. Many mistakes can be corrected easily, without penalty and without notifying the IRS.**

■ contact your tax advisor

■ visit the IRS at [www.irs.gov/ep](http://www.irs.gov/ep)

■ call the IRS at (877) 829-5500



Department of the Treasury  
Internal Revenue Service

Publication 4531 (Rev. 11-2008)  
Catalog Number 48552T

## IRS 401(k) Fix-It Guide

--Trends	-Tips-			
Potential Mistake	How to Find the Mistake	How to Fix the Mistake		How to Avoid the Mistake
		Corrective Action	Correction Program(s) Available	
1) Has your plan document been updated within the past few years to reflect recent law changes? <a href="#">(More)</a>	Review annual cumulative list published close to year-end to see if plan made all required law changes (for example, <a href="#">Notice 2009-98</a> ). <a href="#">(More)</a>	EPCRS VCP: Streamlined application available. See <a href="#">Appendix F</a> and schedules <a href="#">1</a> and <a href="#">2</a> . Adopt amendments for missed law changes. <a href="#">(More)</a>	VCP Audit CAP <a href="#">(More)</a>	Resort to a calendar (tickler) that notes when you must complete amendments. Review your plan document annually. Maintain regular contact with the company that sold you the plan. <a href="#">(More)</a>
2) Are the plan's operations based on the terms of the plan document? Failure to follow plan terms is a very common mistake. <a href="#">(More)</a>	Independent review of plan and its operation. <a href="#">(More)</a>	EPCRS Apply reasonable correction method that would place affected participants in the position they would have been in if there were no operational plan defects. <a href="#">(More)</a>	SCP* VCP Audit CAP <a href="#">(More)</a>	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 you are following plan terms. <a href="#">(More)</a>
3) Is the plan's definition of compensation for all deferrals and allocations used correctly? <a href="#">(More)</a>	Review the plan document. <a href="#">(More)</a>	EPCRS Corrective contribution or distribution. <a href="#">(More)</a>	SCP* VCP Audit CAP <a href="#">(More)</a>	Perform annual reviews of compensation definitions and ensure that the person in charge of determining compensation is properly trained to understand the plan document. <a href="#">(More)</a>
4) Were employer matching contributions made to all appropriate employees under the terms of the plan? <a href="#">(More)</a>	Review the plan document to determine the correct matching contribution formula and compare it to what is used in operation. <a href="#">(More)</a>	EPCRS Base correction upon the plan's terms and other applicable information at the time of the mistake. <a href="#">(More)</a>	SCP* VCP Audit CAP <a href="#">(More)</a>	Contact plan administrators to ensure that they have adequate and sufficient employment and payroll records to make calculations. <a href="#">(More)</a>
5) Has the plan satisfied the 401(k) nondiscrimination tests (ADP and ACP)? <a href="#">(More)</a>	Independent review to determine if highly compensated and nonhighly compensated employees are properly classified. <a href="#">(More)</a>	EPCRS Correction method for ADP/ACP test failures: Make qualified nonelective contributions (QNECs) on behalf of the nonhighly compensated employees Appendix B (section 2.01) One-to-one correction method. <a href="#">(More)</a>	SCP* VCP Audit CAP <a href="#">(More)</a>	Consider a safe harbor plan. Communicate with the plan administrator to ensure proper employee classification. Ensure both you and the plan administrators are familiar with the terms of the plan. <a href="#">(More)</a>

--Trends	-Tips-			
Potential Mistake	How to Find the Mistake	How to Fix the Mistake		How to Avoid the Mistake
		Corrective Action	Correction Program(s) Available	
6) Were all eligible employees identified and given the opportunity to make an elective deferral election (exclusion of eligible employees)? <a href="#">(More)</a>	Review plan document sections on eligibility and participation. Check with plan administrators to find out when employees are entering the plan. <a href="#">(More)</a>	EPCRS 6.02(7), Appendix A (section .05), Appendix B (section 2.02) Employer must make a qualified nonelective contribution (QNEC) to the plan on behalf of the employee that compensates for the missed deferral opportunity. <a href="#">(More)</a>	SCP* VCP Audit CAP <a href="#">(More)</a>	Monitor census information and apply participation requirements. <a href="#">(More)</a>
7) Are elective deferrals limited to the amounts under IRC §402(g) for the calendar year and have any excess deferrals been distributed? <a href="#">(More)</a>	Inspect deferral amounts for plan participants to ensure that the employee has not exceeded the limits. <a href="#">(More)</a>	EPCRS Appendix A (section .04) Distribute excess deferrals. <a href="#">(More)</a>	SCP* VCP Audit CAP <a href="#">(More)</a>	Work with plan administrators to ensure that they have sufficient payroll information to verify the deferral limitations of §402(g) were satisfied. <a href="#">(More)</a>
8) Have you timely deposited employee elective deferrals? <a href="#">(More)</a>	Determine the earliest date you can segregate deferrals from general assets; compare that date with the actual deposit dates and any plan document requirements. <a href="#">(More)</a>	Usually DOL through VFCP for prohibited transaction. May also be EPCRS.  For both VFCP and EPCRS, deposit into the plan's trust all elective deferrals withheld and applicable earnings resulting from the late deposit of amounts to the trust. <a href="#">(More)</a>	SCP* VCP Audit CAP <a href="#">(More)</a>	Coordinate closely with 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. <a href="#">(More)</a>
9) Do participant loans conform to the requirements of the plan document and IRC §72(p)? <a href="#">(More)</a>	Review the plan document and all outstanding loans to ensure the loans comply with the plan's terms and that the employees are repaying their loans timely. <a href="#">(More)</a>	EPCRS 6.07, Appendix F (Schedule 5) Some failures may be corrected by corrective repayment and/or modification of loan terms. <a href="#">(More)</a>	VCP Audit CAP <a href="#">(More)</a>	Review and follow the plan provisions relating to making loans, including the amount of loan, term of the loan and repayment terms. Make sure there are procedures in place to prevent loans that are prohibited transactions. <a href="#">(More)</a>

--Trends	-Tips-			
Potential Mistake	How to Find the Mistake	How to Fix the Mistake		How to Avoid the Mistake
		Corrective Action	Correction Program(s) Available	
10) Were hardship distributions made properly? <a href="#">(More)</a>	Review all in-service distributions and determine that hardship distributions met the plan requirements. <a href="#">(More)</a>	EPCRS Appendix B (section 2.07). Amend plan retroactively to allow for hardship distributions. If impermissible hardship distribution, have participant return hardship distribution amount plus earnings. <a href="#">(More)</a>	SCP* VCP Audit CAP <a href="#">(More)</a>	Be familiar with your plan document's hardship provisions. Implement procedures to ensure you follow the provisions in operation. Ensure that your plan administrators and payroll offices share the plan's hardship distribution information. <a href="#">(More)</a>
11) If the plan was top-heavy, were the required minimum contributions made to the plan? <a href="#">(More)</a>	Review the rules and definitions for top-heavy found in your plan document. Make a determination whether your plan is top-heavy for each plan year. <a href="#">(More)</a>	EPCRS Appendix A (section .02) Properly contribute and allocate the required top-heavy minimum, adjusted for earnings, to the affected non-key employees. <a href="#">(More)</a>	SCP* VCP Audit CAP <a href="#">(More)</a>	Perform a top-heavy test each year. <a href="#">(More)</a>
12) Have you filed a Form 5500 series return and have you distributed a Summary Annual Report (SAR) to all plan participants this year? <a href="#">(More)</a>	Find your signed copy of the return and determine if you filed it timely. <a href="#">(More)</a>	File all delinquent returns. <a href="#">(More)</a>	For Form 5500 filers, see DFVC→ DOL Web site Form 5500-EZ filers must file and ask for abatement of penalties. <a href="#">(More)</a>	Understand your filing requirement and know who filed and when. Don't assume someone is taking care of it for you. <a href="#">(More)</a>  <a href="#">See 401(k) Resource Guide - Plan Sponsors - Filing Requirements</a>

\* In order to utilize SCP, the plan sponsor must have established practices and procedures reasonably designed to promote and facilitate overall compliance with applicable Internal Revenue Code requirements. Also, an analysis of whether mistakes in the aggregate are significant or insignificant needs to be made. If insignificant, correction generally can be made at any time. However, if the mistakes are significant in the aggregate, then the plan sponsor only has two years following the year in which the mistake occurred to correct under SCP.

## 401(k) Plan - Overview

Generally, §401(k) of the Internal Revenue Code (Code) permits an employee to elect to have his/her employer contribute a portion of the employee's wages to a 401(k) plan on a pre-tax basis (elective deferrals). 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 (also known as salary deferrals or salary reduction contributions) are not subject to federal income tax withholding at the time of deferral and they are not reflected as income on the employee's Form 1040, *U.S. Individual Income Tax Return*. For example, if a worker earns \$25,000 in a year and elects to defer \$3,000 into a 401(k) plan, only \$22,000 will be recognized as income on that year's tax return. Although the law does not 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 may permit an employee to designate irrevocably some or all of his or her salary deferrals under the plan as designated Roth contributions. Designated Roth contributions are salary deferrals that, unlike pre-tax elective deferrals, are currently includible in gross income. A designated Roth account is a separate account under a [401\(k\)](#) plan to which [designated Roth contributions](#) are made, and for which separate accounting of contributions, gains and losses is maintained. Designated Roth contributions are treated the same as pre-tax elective contributions for most purposes, including nondiscrimination testing.

A 401(k) plan can have an [automatic enrollment](#) feature. This feature permits the employer to automatically reduce the employee's wages by a fixed percentage or amount and contribute that amount to the 401(k) plan unless the employee has affirmatively chosen not to have his or her wages reduced or has chosen to have his or her wages reduced by a different percentage. These contributions qualify as elective deferrals. This is an effective way for many employers to increase participation in their 401(k) plans.

A 401(k) plan is a "qualified plan." A qualified plan is one that satisfies the requirements listed under §401(a) of the Code. If a plan satisfies these requirements, contributions made by the employer to the plan may be currently deductible and such contributions ordinarily will not be included in employees' gross income until distributed from the plan. If a plan fails to satisfy any of the §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:** A traditional 401(k) plan allows employees who have met the plan's eligibility requirements to make pre-tax elective deferrals or designated Roth contributions to a 401(k) plan through payroll deductions (elective deferrals). In addition, employers have the option of making contributions for all eligible employees, matching contributions based on employees' elective deferrals, other nonelective contributions or any combination of these contributions. These employer contributions can be subject to a vesting schedule which provides that an employee's right to employer contributions becomes nonforfeitable only after a period of time, or they can be immediately vested. Rules relating to traditional 401(k) plans require that plan contributions meet specific nondiscrimination requirements. In order to ensure that the plan satisfies these requirements, the employer must perform annual tests, known as

the Actual Deferral Percentage (ADP) and Actual Contribution Percentage (ACP) tests, to verify that elective deferrals and employer matching contributions do not discriminate in favor of highly compensated employees.

The Pension Protection Act (PPA) encouraged plan sponsors to increase participation in 401(k) plans by incorporating the automatic enrollment feature in traditional 401(k) plans. PPA clarified that the automatic enrollment rules supersede any state or local law that might prohibit or restrict a plan's ability to provide for an automatic contribution arrangement.

In addition, to encourage the use of the automatic enrollment feature, the PPA provided for an eligible automatic contribution arrangement (EACA), that would allow a participant to withdraw automatic enrollment elective deferrals within 90 days of the first contribution made on the participant's behalf without incurring the additional tax under Code §72(t). The EACA provides a participant with a window to reconsider automatic enrollment deferrals. The withdrawn amounts are not considered in the ADP test and matching contributions forfeited on account of the withdrawn amounts are not considered in the ACP test. Another advantage of the EACA is that, as long as 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 under §4979.

Plans with the automatic enrollment feature must take steps to ensure that (in the absence of an election that provides otherwise) amounts are withheld in a timely manner. For a discussion on finding, fixing and avoiding this failure, please see "[The Fix Is In: Correcting a Failure to Implement the Plan's Automatic Enrollment Provisions.](#)"

**Safe harbor 401(k) plans:** A safe harbor 401(k) plan is similar to a traditional 401(k) plan, but, provided the plan meets the safe harbor requirements, the employer does not have to perform the annual ADP or ACP nondiscrimination tests that apply to traditional 401(k) plans. For plan years beginning after December 31, 2007, plan sponsors have two safe harbor designs, each with their own set of rules, from which to choose. The rules for the first option are in Code §401(k)(12). The rules for the second option are in Code § 401(k)(13). The second option is referred to as a qualified automatic contribution arrangement or "QACA."

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

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

Matching contributions made to satisfy the ADP safe harbor requirement are also considered to have satisfied the ACP test. Other matching contributions (i.e. matching contributions not used for satisfying the ADP safe harbor) are generally subject to the ACP test unless certain other requirements are met. 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, the ADP safe harbor requirement can be satisfied by making a nonelective contribution that is equal to at least 3% of compensation for each eligible NHCE.

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

- (1) Automatic enrollment feature: A plan designed to satisfy the design option under Code §401(k)(12) is not required to provide for an automatic enrollment feature. On the other

hand, a QACA must provide for an automatic enrollment feature that satisfies certain requirements. The automatic enrollment feature requires that unless the employee affirmatively elects otherwise, the employee is to be treated as if he or she elected to have the employer make elective contributions equal to a certain percentage of compensation. Under a QACA, the elective contribution made for an automatically enrolled employee cannot be less than 3% of compensation for the initial period (which begins on the date the first contribution is made under automatic enrollment and ends on the last date of the full plan year following the date of contribution), 4% for the plan year following the initial period, 5% for the second plan year following the initial period and 6% for the years that follow. An employer may set the automatic contribution amount at a percentage that is higher than the minimums, but the percentage cannot be higher than 10% of compensation. The notice provided to participants under a QACA must explain the employee's right to elect not to have elective contributions made on the employee's behalf (or elect to have such contributions made at a different percentage). The notice should also explain how the contributions will be invested, in the absence of any specific election by the employee.

- (2) ADP safe harbor matching contributions: Matching contributions made for an employee, for satisfying the ADP safe harbor requirement under Code §401(k)(12) should, for each level of an employee's deferral, be greater than or equal to the matching contribution under the following formula:

100% of elective contributions that do not exceed 3% of compensation plus 50% of elective contributions in excess of 3% of compensation but not in excess of 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 greater than or equal to the matching contribution under the following formula:

100% of elective contributions that do not exceed 1% of compensation plus 50% of elective contributions in excess of 1% of compensation but not in excess of 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 § 401(k)(12), employees are required to be fully vested in ADP safe harbor contributions made for them.

In a QACA, the plan could require that an employee complete two years of vesting service before he or she can be vested in the ADP safe harbor contributions made on his or her behalf.

Employers sponsoring safe harbor 401(k) plans must also satisfy certain employee notice requirements. The notice requirements are satisfied if the employer provides each eligible employee with written notice of the employee's rights and obligations under the plan and the notice satisfies content and timing requirements.

In order to satisfy the content requirement, the notice must describe the safe harbor method used, how eligible employees make elections, any other plans involved, etc.

The timing requirement necessitates that the employer provide notice within a reasonable period before each plan year. The law deems this requirement satisfied if the notice is provided to each eligible employee at least 30 days and not more than 90 days before the beginning of

each plan year. The regulations provide for other guidelines in certain cases where complying with the 30 to 90 day requirement may not be feasible (for example, where an employee becomes eligible after the 90th day before the beginning of the plan year or in the case of a new employee where the plan provides that the employee is immediately eligible to have elective contributions made on the employee's behalf).

In certain circumstances, the failure to provide notice could have the effect of erroneously excluding eligible employees. For a discussion on finding, fixing and avoiding the failure to provide notice, see [“The Fix is In: The Failure to Provide a Safe Harbor Notice.”](#)

Both the traditional and safe harbor plans are for employers of any size and employers can maintain them in addition to other retirement plans. It is important that you become familiar with your plan so that you understand the special rules that apply to you.

**SIMPLE 401(k) plans:** SIMPLE 401(k) plans were created so that small businesses could have an effective, cost-efficient way to offer retirement benefits to their employees. A SIMPLE 401(k) plan is not subject to the annual ADP and ACP nondiscrimination tests that apply to a traditional 401(k) plan. 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 available to employers with 100 or fewer employees who received at least \$5,000 in compensation from the employer for the preceding calendar year. In addition, employees that are covered by a SIMPLE 401(k) plan may not receive any 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 utilize the IRS's Employee Plans Compliance Resolution System (EPCRS) to remedy your mistakes and avoid the consequences of plan disqualification. A correction for a mistake should be reasonable and appropriate. The correction methodology should resemble one already provided for in the Code and you should consider all applicable facts and circumstances. [Rev. Proc. 2008-50, 2008-35 I.R.B. 464](#) sets forth the EPCRS. There are three components of 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 the IRS's 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:

### SCP:

- In order to be eligible for SCP, the plan sponsor or administrator of a plan must have established practices and procedures (formal or informal) reasonably designed to promote and facilitate overall compliance with applicable IRS requirements. For example, the plan administrator of a qualified plan that may be top-heavy under Code §416 may include in its plan operating manual a specific annual step to determine whether the plan is top-heavy and, if so, to ensure that the minimum contribution requirements of the top-heavy rules are satisfied. 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 terms of your plan. SCP is not available for other types of problems, such as the failure to keep your plan document up to date to reflect changes in the law.
- The plan sponsor effects correction using the General Correction Principles set forth in Rev. Proc. 2008-50.
- A plan sponsor that corrects a failure listed in, and in accordance with, the correction methods included in Appendix A or Appendix B of Rev. Proc. 2008-50 may be certain that the correction effected is reasonable and appropriate for the failure.
- If needed, the plan sponsor effects changes to its administrative procedures to ensure the failures 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.
- If a plan sponsor does not correct Operational Failures in its plan(s) within the two-year self-correction period, the plan sponsor may use the Self-Correction Program if, considering all of the facts and circumstances, the failures, 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.

### VCP:

- The plan sponsor identifies the failures.
- The plan sponsor proposes correction using the General Correction Principles set forth in Rev. Proc. 2008-50, section 6.

- The plan sponsor proposes changes to its administrative procedures to ensure the failures do not recur.
- The plan sponsor pays a compliance fee that generally is based on the number of plan participants as reported on the most recently filed Form 5500 series return according to the following chart:

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

- The IRS issues a Compliance Statement with respect to the plan detailing the qualification failures identified by the plan sponsor and the applicable correction methods approved by the IRS.
- The plan sponsor corrects the identified failures within 150 days of the issuance of the Compliance Statement.
- While the submission is pending, Employee Plans will not examine the plan, except under unusual circumstances.

**Audit CAP:**

- The plan sponsor or plan is Under Examination.
- The plan sponsor enters into a Closing Agreement with the IRS.
- The plan sponsor effects correction prior to entering into the Closing Agreement.
- The plan sponsor pays a sanction negotiated with the IRS.
- The sanction paid under Audit CAP should be greater than the fee paid under VCP.
- For plans intended to be qualified, the sanction under Audit CAP is a negotiated percentage of the Maximum Payment Amount (MPA) based on the sum for all open taxable years of the:
  - 1) Tax on the trust (Form 1041) (and any interest and penalties applicable to the trust tax return).
  - 2) Additional income tax resulting from the loss of employer deductions for plan contributions (and any interest and penalties applicable to 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 applicable to the participants' tax return).

[Return to Table](#)

--Trends	-Tips-			
Potential Mistake	How to Find the Mistake	How to Fix the Mistake		How to Avoid the Mistake
		Corrective Action	Correction Program(s) Available	
1) Has your plan document been updated within the past few years to reflect recent law changes? <a href="#">(More)</a>	Review annual cumulative list published close to year-end to see if plan made all required law changes (for example, <a href="#">Notice 2009-98</a> ). <a href="#">(More)</a>	EPCRS VCP: Streamlined application available. See <a href="#">Appendix F</a> and schedules <a href="#">1</a> and <a href="#">2</a> . Adopt amendments for missed law changes. <a href="#">(More)</a>	VCP Audit CAP <a href="#">(More)</a>	Resort to a calendar (tickler) that notes when you must complete amendments. Review your plan document annually. Maintain regular contact with the company that sold you the plan. <a href="#">(More)</a>

## 1) Has your plan document been updated within the past few years to reflect recent law changes?

Laws related to retirement plans change quite frequently. There are statutory deadlines for which many provisions must become effective. The IRS generally establishes a firm deadline for adopting these changes. Also, these law changes might mean you can simplify some areas of plan administration or improve benefits. You will need to change plan language and operation to keep the plan within the law and to take advantage of increased benefit limits.

[Return to Table](#)

### How to Find the Mistake:

At some point in the plan's existence, you may need to demonstrate your plan has complied with current and prior law. This request may come from a financial institution, third party administrator (TPA) or other plan service provider, or it may come from the IRS during an audit or if you file a [determination letter request](#). You may be asked to demonstrate the plan has complied with all current and prior law, sometimes reaching back several years.

You may have a written plan document that is a [pre-approved plan or an individually designed plan](#). A pre-approved plan is one in which you adopt a plan that has already been reviewed favorably by the IRS. The two main types of pre-approved plans are [Master & Prototype plans \(M&P\)](#) and [Volume Submitter plans \(VS\)](#). M&P sponsors and VS practitioners submit these respective plans in order to obtain an opinion or advisory letter providing the IRS's approval. 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 has not pre-reviewed it.

You may apply for a determination letter from the IRS to ensure that your retirement plan is written in accordance with the rules of the Code and that necessary amendments to the plan have been adopted when required by law. If your plan is a pre-approved plan, you have a level of assurance that the plan is written in compliance with the law even if you do not apply for a determination letter.

Following is a list of documents you should keep in order to prove you have timely amended your plan:

- Original plan document.
- All subsequent amendments or restatements to the plan document.
- All adoption agreements - An adoption agreement is a document provided by a vendor (for example, M&P sponsor or VS practitioner) that allows you to choose plan design options. The adoption agreement reflects specific choices made by you for your plan, including eligibility requirements, the types and amounts of contributions allowed, the allocation method for employer contributions, the vesting schedule applicable to employer contributions and the distribution options. The adoption agreement is not the complete plan document and must be accompanied by a basic plan document, which provides in-depth details of how the plan must operate.
- Any Opinion Letter or Advisory Letter issued by the IRS.
- Any determination letter issued by the IRS.
- Board of Director's resolutions and minutes, or similar records related to the plan.

The PPA includes a number of significant tax incentives to enhance and protect retirement savings for millions of Americans. Changes impacting 401(k) plans include:

- Making EGTRRA provisions permanent. Under EGTRRA, the increased contribution limits, catch-up contribution provisions and the facility for Roth 401(k) contributions were scheduled to expire after 2010.
- Faster vesting schedule for employer nonelective contributions
- Providing additional options to plans to take advantage of automatic enrollment, including :
  - The addition of a new safe harbor 401(k) option under Code §401(k)(13).
  - The addition of a design option that includes automatic enrollment, under Code §414(w).
- Requiring plans to allow eligible participants to divest their account balances from employer securities and invest the proceeds in other more diversified investments

Generally, plans should have been amended to incorporate the provisions of PPA by the end of the first plan year that begins on or after January 1, 2009. In limited circumstances (e.g. amendments to relating to the diversification of investments), the deadline for adopting the PPA amendment could be the end of the first plan year that begins on or after January 1, 2010 (for amendments that have the extended deadline see [Notice 2009-97](#)).

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) brought a host of changes intended to simplify plan administration while improving benefits. Among the many EGTRRA changes are:

- [Catch-up contributions](#) for participants age 50 and over
- [Increased contribution limits](#)
- [Increased compensation limits](#)
- [Higher deduction limits](#)

You must adopt certain provisions of EGTRRA, while other provisions are optional. The deadline for amending your plan to reflect a change made by EGTRRA depends on whether the EGTRRA change is mandatory or optional. Generally, the deadline for adopting a mandatory EGTRRA change was on or before the end of the 2002 plan year, since most of the changes become effective in 2002. You may choose to implement an optional, or discretionary, provision of EGTRRA. Any discretionary provision that you implement requires a plan amendment by the end of the plan year in which you used those provisions in the operation of the plan. As long as you adopt your EGTRRA plan amendments within these timeframes and the amendments were

a good faith effort to comply with EGTRRA, you have additional time to fix problems with the plan language (if any), apply for a determination letter from the IRS, and make any corrections to your EGTRRA amendments that you may need. However<sup>1</sup>, if you did not adopt an amendment on a timely basis, you are a late amender or a nonamender - your plan does not comply with the law and is no longer qualified.

The most recent statutory changes preceding EGTRRA are referred to as GUST. GUST is a grouping of major and minor law changes with varying effective dates depending on the type of plan you have.

The term "GUST" refers to the following Acts:

- Uruguay Round Agreements Act, Pub. L. 103-465 which implemented the Uruguay Round of General Agreement on Tariffs and Trade ("GATT");
- Uniformed Services Employment and Reemployment Rights Act of 1994, Pub. L. 103-353 ("USERRA");
- Small Business Job Protection Act of 1996, Pub. L. 104-188 ("SBJPA");
- Taxpayer Relief Act of 1997, Pub. L. 105-34 ("TRA '97");
- Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. 105-206 ("RRA '98"); and
- Community Renewal Tax Relief Act of 2000, Pub. L. 106-554 ("CRA").

You generally needed to adopt GUST provisions by February 28, 2002, for individually designed plans and September 30, 2003, for pre-approved plans. If you did not adopt your plan's GUST provisions by the applicable due date, then you are a late/nonamender and your plan does not comply with the law and is no longer qualified.

In addition to statutory and regulatory changes, the IRS continues to provide guidance on qualification requirements, which must be accounted for in keeping plans up to date.

The IRS publishes annually a Cumulative List of Changes in Plan Qualification Requirements toward the end of each year. The Cumulative List will help you understand what amendments have to be finalized in your plan by the end of your current 5-year cycle (discussed below). The most current Cumulative List is Notice 2009-98. The Cumulative List in [Notice 2009-98](#) is for Cycle E plan sponsors to use in drafting their plans for the submission period ending on January 31, 2011.

**In February of 2005, IRS changed its determination letter program and the rules for when a plan sponsor has to amend its plan for changes in the law.**

#### [New Submission Procedures for Individually Designed Plans - 5-Year Remedial Amendment Cycle](#)

If you maintain an individually designed plan and you want continuing assurance that your plan document meets the requirements of the law, you will need to submit applications for determination letters only once every five years, under a staggered system of 5-year remedial amendment cycles (Cycles A - E). Generally, the cycle that applies to your plan depends on the last digit of your Employer Identification Number (EIN). Your submission period occurs in the last 12 months of your remedial amendment cycle.

For example, the first 5-year period for plans falling into Cycle E ends on January 31, 2011. If you fall under Cycle E based on a last digit EIN of 5 or 0, you would submit your determination

---

<sup>1</sup> See discussion on Interim Amendments, below.

letter application between February 1, 2010 and January 31, 2011. A [chart](#) is available for reference so you can determine your cycle.

Under this system, when you file your determination letter application, you will have the opportunity to make any necessary corrections to good faith, [interim and discretionary amendments](#) you adopted during the 5-year cycle, provided you adopted these interim and discretionary amendments on time and in good faith.

**Interim amendments** are required to keep a written plan document up to date between a plan's submission periods during the applicable remedial amendment cycles. Other amendments are discretionary amendments. The general deadline for timely adoption of an interim or discretionary amendment can be found in section 5.05 of [Rev. Proc. 2007-44](#). 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 the last day of the plan year that includes the date on which the amendment is effective. A plan sponsor must adopt a discretionary amendment by the end of the plan year in which the plan amendment is effective - for a calendar year plan, this would be December 31 of the year in which the amendment becomes effective.

Interim amendments include one or more of the following:

- The good faith EGTRRA amendments described in [Notices 2001-42](#) and [2005-5](#);
- Amendments required for compliance with the final and temporary regulations under §401(a) (9), relating to minimum distributions, as described in [Rev. Proc. 2002-29](#) (as modified by [Rev. Proc. 2003-10](#)); and
- Interim amendments described in section 5 of [Rev. Proc. 2007-44](#).

An interim amendment does not include any amendment adopted to correct a mistake to operate the plan in accordance with the plan's terms. For example, if a plan provides for a 6-year graded vesting schedule and the plan operated on a 5-year graded vesting schedule, a corrective amendment providing for a 5-year graded vesting schedule is not an interim amendment.

In addition, an interim amendment does not include any amendment adopted to comply with legislation for which the remedial amendment period has already expired. Thus, an amendment adopted to bring a plan into compliance with GUST or any other previous legislation is not a good faith or interim amendment.

#### [New Submission Procedures for Pre-Approved Plans](#)

The IRS has also changed its procedures regarding pre-approved plans so that M&P sponsors and VS practitioners will restate and submit the plans to the IRS for pre-approval only once every six years. Likewise, if you have adopted a pre-approved plan, you will need to adopt the restated plan only once every six years, and if you want continued assurance on a determination letter, you will need to apply for a new letter only at that time. The IRS will notify the M&P sponsor or VS practitioner when you must adopt the restated plan.

We recommend you contact the person who sold you the plan to discuss the status of your plan document.

[Return to Table](#)

## **How to Fix the Mistake:**

### **Corrective Action:**

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

- Adopt amendment(s) for the law changes you have missed. You may be able to utilize model or sample amendments published by the IRS that apply to your 401(k) plan. You will need to confirm that the operation of the plan is consistent with plan's terms.
- Model amendments issued by the IRS may be useful for plan sponsors in the effort to amend the plan to conform with applicable law changes. The following items of guidance released by the IRS contain model or sample plan amendments:
  - Sample plan amendments for complying with EGTRRA (See [Notice 2001-57](#)).
  - Model plan amendments for complying with final and temporary regulations under Code §401(a)(9) (See [Rev. Proc. 2002-29](#)).
  - Sample plan amendment for complying with the automatic rollover rule under EGTRRA (See [Notice 2005-5](#))
  - Sample plan amendment for sponsors, practitioners and employers (plan sponsors) who want to provide for designated Roth contributions in their § 401(k) plans (See [Notice 2006-44](#))
  - Sample plan amendments for sponsors to use to add the automatic enrollment feature to their plans (See [Notice 2009-65](#)) Sample Amendment 1 can be used to add an automatic contribution arrangement to a §401(k) plan. Sample Amendment 2 can be used to add an eligible automatic contribution arrangement described in Code §414(w) (permitting 90-day withdrawals) to a §401(k) plan.
- Also, you may adopt a pre-approved plan from an M&P sponsor or VS practitioner. In this case, entering into the VCP is a quicker process since the scope of review for the IRS is limited. The IRS has already reviewed the provisions in the pre-approved plan adopted by the employer, as opposed to an individually designed plan, where the IRS would have to review the entire plan document.
- The effective date of the amendment should be retroactive to conform the plan's terms to the requirements of the applicable legislation.
- File a VCP submission with the IRS using Rev. Proc. 2008-50.

If the only mistake in the VCP submission involves the late adoption of good faith ([see EGTRRA explanation, above](#)) or interim amendments ([see explanation, above](#)), then, [Appendix F, Schedule 1 of Rev. Proc. 2008-50, a simplified filing procedure](#), can be utilized by the plan sponsor. The resolution of an EGTRRA good faith, interim, or optional amendment failure, using schedule 1, results in the corrective amendment being treated as if it had been adopted timely for purposes of determining the availability of the extended remedial amendment period (RAP). The fee for the submission is \$375. Schedule 1 is not available if the required amendment is not adopted by the time the plan's extended RAP expires. If the amendment is adopted after the expiration of the RAP, then the plan sponsor should use Appendix F, [Schedule 2](#). For details on how nonamender failures should be resolved under VCP, please see "[Nonamender failures and the Voluntary Correction Program \(VCP\)](#)."

[Return to Table](#)

### **Correction Program(s) Available:**

#### **SCP:**

Plan sponsors may not correct this type of mistake under SCP. SCP is limited to operational problems and this mistake is the result of the failure to keep the plan language up to date. In order to retain plan qualification, plan sponsors must correct this mistake under VCP.

### **VCP:**

The plan sponsor makes a VCP submission to the IRS pursuant to Rev. Proc. 2008-50 identifying the failure.

The fee for this size plan would normally be \$1,000; however, if the failure to make timely good faith amendments is the only mistake in the submission, the rev. proc. provides for a reduced fee of \$375 regardless of the number of participants in the plan (see section 12.03 of Rev. Proc. 2008-50). Plan Sponsor X may use the streamlined application procedure for good faith nonamenders in Appendix F, Schedule 1 of Rev. Proc. 2008-50.

### **Example:**

Same facts as prior example, except that Plan Sponsor X does not timely amend its plan for changes in the law mandated by EGTRRA. X should have amended its plan by the end of Cycle C to be considered timely amended.

The fee in this case is generally \$1,000; however, if X's only mistake was being a late amender for Cycle C (due date/end of remedial amendment cycle was January 31, 2009) and X files a VCP submission within one year of the end of Cycle C (by January 31, 2010), then X's fee would be reduced by 50% of the normal fee provided for in the fee chart ( $\$1,000 \times 50\% = \$500$ ) see section 12.03 of Rev. Proc. 2008-50).

### **Audit CAP:**

If this mistake is discovered on audit, you may correct it under Audit CAP. Correction of the plan under Audit CAP should be very similar to correction under SCP. The sanction under Audit CAP is a percentage of the [Maximum Payment Amount \(MPA\)](#). In addition, a nonamender mistake discovered by the revenue agent during the determination letter process is subject to a higher fee than if you bring the mistake to the attention of the agent in the application. If you have filed for a determination letter and discover you may be a nonamender, bring this to the attention of the agent in order to avoid the higher fee under section 14.04 of Rev. Proc. 2008-50.

[Return to Table](#)

### **How to Avoid the Mistake:**

There are a number of ways to avoid this mistake:

- Resort to a calendar (tickler file) that notes when you must complete amendments.
- Do an annual review of your plan document.
- Make sure your plan document and Summary Plan Description (SPD) match. If you amend your plan document, check the language against the old plan document, noting any differences.
- Knowing you have 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 is amended. We recommend you maintain contact, on at least a yearly basis, with the company that sold you the plan. If the company sends you a set of amendments to formally adopt, make certain you timely execute the documents per their instructions. Keep signed and dated copies of your plan document and any amendments for your records.

[Return to Table](#)

--Trends	-Tips-			
Potential Mistake	How to Find the Mistake	How to Fix the Mistake		How to Avoid the Mistake
		Corrective Action	Correction Program(s) Available	
2) Are the plan's operations based on the terms of the plan document? Failure to follow plan terms is a very common mistake. <a href="#">(More)</a>	Independent review of plan and its operation. <a href="#">(More)</a>	EPCRS Apply reasonable correction method that would place affected participants in the position they would have been in if there were no operational plan defects. <a href="#">(More)</a>	SCP* VCP Audit CAP <a href="#">(More)</a>	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 you are following the plan terms. <a href="#">(More)</a>

## 2) Are the plan's operations based on the terms of the plan document?

The plan sponsor/employer is ultimately responsible for keeping the plan in compliance with applicable tax laws; however, there may be many employees, vendors and tax professionals servicing your plan. This retirement team may include many people in a large plan or as few as one in a small plan.

The fiduciary responsibility rules in Title I of the Employee Retirement Income Security Act (ERISA) under the jurisdiction of the Department of Labor (DOL) require that fiduciaries follow the terms of the plan insofar as they are consistent with ERISA. 29 U.S.C. 1104(a)(1)(D).

You should convey any changes made to your plan document or to the operation of your plan to everyone providing service to your plan. For example, assume you amend your plan document to change the definition of compensation. You should communicate that change to all persons involved in determining deferral amounts withheld from the participant's pay, performing your plan's nondiscrimination tests, or allocating employer contributions. Communication among the people who service your plan is essential for a compliant plan. Also, if you decide to implement a different definition of compensation in operation, make sure you amend the plan timely to reflect that change. Below are some common changes where due diligence is needed to identify any potential mistakes.

- If you made any changes to your plan document, you should inform all persons who service your plan of those changes and what they mean to the operation of your plan.
- If you amend your plan document, you should also amend your summary plan description (SPD). If you materially modify your plan, you must give a summary of the material modifications (SMM) to the 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, you should communicate those changes to the persons providing service to your plan. You may need to reflect these changes in your plan document through a plan amendment.
- If you've changed the trustees for your plan, you need to convey those changes and you may need to update your plan document and SPD.

- Any changes in the ownership interests may affect the nondiscrimination testing for the plan and you should convey it to your plan service providers. You should notify your plan service providers of any acquisitions made by your business.

[Return to Table](#)

### **How to Find the Mistake:**

You must be familiar with your plan document to be able to find whether you have operated the plan in accordance with its terms. Following the terms of the plan document is crucial to ensure tax-favored treatment of the plan and to prevent a breach of fiduciary duty under Title I of ERISA. Be familiar with the wording in the plan document and how it affects the plan's operation. Conduct an independent review of your plan and its operation on an annual basis. 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](#).

[Return to Table](#)

### **How to Fix the Mistake:**

#### **Corrective Action:**

If you find an error in the operation of your plan, you should correct the error as soon as feasible. Use a reasonable correction method that would place affected participants in the position they would have been in had there been no operational plan defects. Section 6 of Rev. Proc. 2008-50 provides general correction principles that you should use in determining an appropriate method of correction. The examples in Appendices A and B of Rev. Proc. 2008-50 are deemed reasonable and appropriate correction methods.

#### **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, 2005, to September 30, 2008, when he terminated employment. Bob worked 2,000 hours in 2005, 2006 and 2007, and during 2008, 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 account balance due to employer matching contributions 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 Bob should have been credited with a vesting year of service for the final year of employment, 2008, since he had worked in excess of 1,000 hours in that plan year. Bob should have been vested at 80% for the 4 years of vesting service.

#### **Reasonable Correction:**

Employer A needs to make a corrective distribution to Bob in order 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.

[Return to Table](#)

## **Correction Program(s) Available:**

### **SCP:**

The example illustrates an operational problem, in that the employer failed to follow the terms of the plan by improperly applying the vesting provisions to Bob. Therefore, if the other eligibility requirements of SCP are satisfied, Employer A 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 A needs to make corrective distribution by December 31, 2010.
  - If not corrected by December 31, 2010, Employer A is not eligible for SCP and must correct under VCP. Even if A makes correction by December 31, 2010, A may only use SCP if it satisfied the other requirements of SCP.
- 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 is dependent on all the facts and circumstances.

### **VCP:**

Under VCP, correction is the same as described above under SCP. Employer A makes a VCP submission in accordance with Rev. Proc. 2008-50. The fee for the VCP submission is \$2,500 (per the [table](#) in section 12.02 of Rev. Proc. 2008-50).

### **Audit CAP:**

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 \(MPA\)](#).

[Return to Table](#)

### **How to Avoid the Mistake:**

Be sure that you apply the provisions of the plan correctly when making a determination of what contributions or benefits you will provide to participants. Plan sponsors need to develop a communication mechanism to make all relevant parties aware of changes on a timely and accurate basis (best practices).

[Return to Table](#)

--Trends	-Tips-			
Potential Mistake	How to Find the Mistake	How to Fix the Mistake		How to Avoid the Mistake
		Corrective Action	Correction Program(s) Available	
3) Is the plan's definition of compensation for all deferrals and allocations used correctly? <a href="#">(More)</a>	Review the plan document. <a href="#">(More)</a>	EPCRS Corrective contribution or distribution. <a href="#">(More)</a>	SCP* VCP Audit CAP <a href="#">(More)</a>	Perform annual reviews of compensation definitions and ensure that the person in charge of determining compensation is properly trained to understand the plan document. <a href="#">(More)</a>

### 3) Is the plan's definition of compensation for all deferrals and allocations used correctly?

Because your plan may use different definitions of compensation for different purposes, it is important that you apply the proper definition when dealing with deferrals and allocations. A plan's definition of compensation must satisfy applicable rules for determining the amount of contributions. The amount of compensation taken into account under the plan cannot exceed \$245,000 in 2010, and is subject to [cost-of-living adjustments](#) for later years. This limit is described in §401(a)(17) of the Code.

You must follow the plan document's definition of compensation in the operation of the plan. 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 by an employee, including, but not limited to, the following items:
  - Commissions and tips.
  - Fringe benefits.
  - Bonuses.

You may not be aware your plan contains different definitions of compensation for different plan purposes. In some cases, you or the plan administrator may use the incorrect definition of compensation when determining the compensation eligible to be deferred, computing the matching contribution and when calculating the ADP or ACP test. Also, you or the plan administrator may fail to limit compensation as required under Code §401(a)(17).

[Return to Table](#)

#### **How to Find the Mistake:**

To determine if you are using the proper compensation for allocations and deferrals as required by the plan, you'll need to review the plan document. Many plan sponsors operate their plans based on a short summary of the plan containing many of the definitions and operational requirements. However, as the plan is amended, the compensation definition may change while the plan continues to operate as it had previously.

Review the plan section that deals with allocations and deferrals. Each plan document contains a section, either in the plan document or in an attached adoption agreement, which discusses how the plan must make allocations and/or deferrals. This section will 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 are using the correct compensation. Some of these definitions can get very 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, develop a worksheet to calculate the correct amounts.

[Return to Table](#)

### **How to Fix the Mistake:**

#### **Corrective Action:**

There are a couple of ways to make corrections when amounts are improperly allocated based on compensation. If you have improperly determined elective deferrals, you should make a distribution of the excess amount plus earnings to the participant. If there are improper profit-sharing allocations, you should forfeit and reallocate the allocations plus earnings to plan participants or place them in an unallocated account for later use. Of course, an improper allocation may also result in an under contribution. If this occurs, you would make a corrective contribution, including earnings, for the affected participants.

#### **Example:**

Employer Z sponsors a 401(k) plan for its employees. There are 16 participants in the plan. The plan's definition of compensation for deferrals and allocations was amended, effective 2004, to exclude bonuses. For the 2008 plan year, Employer Z did not exclude bonuses from compensation before determining allocations and deferrals. There were three highly compensated employees (HCEs) who each had base compensation of \$120,000 and a \$30,000 bonus. Each of these HCEs 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 HCEs 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 HCEs properly deferred 6% of their \$120,000 base compensation (\$7,200), but improperly deferred 6% of the \$30,000 bonus (\$1,800).

#### **Correction:**

For each HCE, forfeit the profit-sharing allocations of \$1,500 plus earnings and place such allocations in an unallocated account to use for profit-sharing allocations in future plan years. Distribute the improperly allocated elective deferrals of \$1,800 plus earnings to each of the three HCEs.

[Return to Table](#)

### **Correction Program(s) Available:**

#### **SCP:**

The example illustrates an operational problem, in that the employer failed to follow the terms of the plan by failing to exclude bonuses from compensation used to determine allocations under

the plan. Therefore, if the other eligibility requirements of SCP are satisfied, Employer Z 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 Z needs to complete correction by December 31, 2010.
  - If not corrected by December 31, 2010, Employer Z is not eligible for SCP and must correct under VCP. Even if Z makes correction by December 31, 2010, it may only use SCP if the other requirements of SCP are satisfied.
- 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 is dependent on all the facts and circumstances.

#### **VCP:**

Under VCP, correction is the same as described, above, under SCP. Employer Z makes a VCP submission in accordance with Rev. Proc. 2008-50. The fee for the VCP submission is \$750 (per the [table](#) in section 12.02 of Rev. Proc. 2008-50).

#### **Audit CAP:**

Under Audit CAP, correction is the same as described, above, 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 \(MPA\)](#).

[Return to Table](#)

#### **How to Avoid the Mistake:**

There are a number of ways to avoid this mistake:

- Perform annual reviews of your plan's operations.
- If you amend your plan document, check the definitions against the old plan document, noting any differences.
- If you amend your plan document, communicate those changes to everyone involved in the plan's operations.
- Make sure you properly train the person in charge of determining compensation to understand the plan document.
- Know what your third-party administrators have agreed to provide for you. They may be relying on you for all information, such as compensation and deferral amounts, used in their own work.
- If possible, simplify your plan's definition of compensation and use the same definition for multiple purposes.

[Return to Table](#)

--Trends	-Tips-			
Potential Mistake	How to Find the Mistake	How to Fix the Mistake		How to Avoid the Mistake
		Corrective Action	Correction Program(s) Available	
4) Were employer matching contributions made to all appropriate employees under the terms of the plan? <a href="#">(More)</a>	Review the plan document to determine the correct matching contribution formula and compare it to what is used in operation. <a href="#">(More)</a>	EPCRS Base correction upon the plan's terms and other applicable information at the time of the mistake. <a href="#">(More)</a>	SCP* VCP Audit CAP <a href="#">(More)</a>	Contact plan administrators to ensure that they have adequate and sufficient employment and payroll records to make calculations. <a href="#">(More)</a>

**4) Were employer matching contributions made to all appropriate employees under the terms of the plan?**

Employers sometimes fail to contribute the employer matching contribution provided for under the plan document's terms. 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 and/or the plan service providers fail to follow the terms of the plan document. Another common problem is using the incorrect definition of compensation described in the plan document for determining matching contributions. For example, you or your administrator may not include deferrals in compensation as required under the plan document when calculating the matching contribution.

Another problem has to do with 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 specified 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.

[Return to Table](#)

**How to Find the Mistake:**

To avoid mistakes in this area, review the plan document as it relates to matching contributions.

- 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.

[Return to Table](#)

## 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 (see section 6.02 of Rev. Proc. 2008-50).

### Example:

Employer D sponsors a 401(k) plan with a calendar-year plan year. The plan has 20 participants. The plan document provides that the employer will make matching contributions based on an employee's elective deferrals for the year. It further provides that the match will equal 50% of the amount deferred by the participant for the year up to 6% of compensation. Therefore, a participant deferring at least 6% of compensation should have a matching contribution allocation of 3% of compensation. The plan allows participants to change their deferral levels at stated intervals during the year.

During the 2008 plan year, the plan sponsor 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% rate of deferral ( $\$50,000 \times 8\% = \$4,000$  elective deferrals). Employer D provided a matching contribution to Carla totaling \$750 ( $\$50,000 \times 3\% \times 50\%$  limitation). Under the terms of the plan, Carla was entitled to a \$1,500 match ( $\$50,000 \times 6\% \times 50\%$  limitation). As a result, Employer D needs to make a corrective contribution of \$750 plus earnings for Carla to correct the operational mistake.

[Return to Table](#)

## Correction Program(s) Available:

### SCP:

The example illustrates an operational problem, in that the employer failed to follow the terms of the plan by improperly applying the matching contribution formula under the plan. Therefore, 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, 2010.
  - If not corrected by December 31, 2010, Employer D is not eligible for SCP and must correct under VCP. Even if D makes correction by December 31, 2010, it may only use SCP if the other requirements of SCP are satisfied.
- 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 is dependent on all the facts and circumstances.

### VCP:

Under VCP, correction is the same as described, above, under SCP. Employer D makes a VCP submission in accordance with Rev. Proc. 2008-50. The fee for the VCP submission is \$750 (per the [table](#) in section 12.02 of Rev. Proc. 2008-50).

**Audit CAP:**

Under Audit CAP, correction is the same as described, above, 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 \(MPA\)](#).

[Return to Table](#)

**How to Avoid the Mistake:**

You need to be familiar with the terms of your plan and implement procedures to ensure that your plan operates in accordance with your plan document. You should work with your plan administrators to ensure that they have sufficient employment and payroll information to calculate the employer matching contribution described under the terms of the plan document.

[Return to Table](#)

--Trends	-Tips-			
Potential Mistake	How to Find the Mistake	How to Fix the Mistake		How to Avoid the Mistake
		Corrective Action	Correction Program(s) Available	
5) Has the plan satisfied the 401(k) nondiscrimination tests (ADP and ACP)? <a href="#">(More)</a>	Independent review to determine if highly compensated and nonhighly compensated employees are properly classified. <a href="#">(More)</a>	EPCRS Correction method for ADP/ACP test failures: Make qualified nonelective contributions (QNECs) on behalf of the nonhighly compensated employees Appendix B (section 2.01) One-to-one correction method. <a href="#">(More)</a>	SCP* VCP Audit CAP <a href="#">(More)</a>	Consider a safe harbor plan. Communicate with the plan administrator to ensure proper employee classification. Ensure both you and the plan administrators are familiar with the terms of the plan. <a href="#">(More)</a>

## 5) Has the plan satisfied the 401(k) nondiscrimination tests (ADP and ACP)?

What are the ADP and ACP tests? Plan sponsors must test traditional 401(k) plans annually to ensure that the amount of contributions made by and for rank-and-file employees, (nonhighly compensated employees (NHCEs)), are proportional to contributions made for owners and managers, ([highly compensated employees \(HCEs\)](#)). As the NHCEs save more for retirement, the rules allow HCEs to defer more. These nondiscrimination tests for 401(k) plans are known as the Actual Deferral Percentage (ADP) and Actual Contribution Percentage (ACP) tests.

The ADP test applies to elective deferrals (including both before-tax deferrals and Roth deferrals) of the HCEs and NHCEs. Dividing the elective deferrals by the compensation for an individual participant will give you that participant's Actual Deferral Ratio (ADR). Add up the ADR for each individual participant who is a NHCE (even if they chose not to make an elective deferral) and divide by the total number of NHCEs and you'll have the ADP for the NHCE group. Do the same for the HCEs to determine their ADP. Calculate ACP in the same manner, instead using the matching contributions and employee contributions (not including deferrals) for each participant, divided by the compensation.

The ADP test is met if the ADP for the eligible HCEs does not 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 group of NHCEs plus 2%.

The ACP test is met if the ACP for the eligible HCEs does not 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 group of NHCEs plus 2%.

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

An important aspect of performing the ADP and ACP tests is to identify properly the HCEs. Code §414(q) defines HCEs to include generally any employee who:

- Was a 5% owner at any time during the year or preceding year (a 5% owner is someone who owns more than 5% of the employer), or
- For the preceding year had compensation from the employer in excess of \$110,000 (for 2010 and subject to [cost-of-living adjustments](#) in later years) and, if the employer elects, was a member of the top-paid group (top 20%) of employees.

Remember, when you're determining ownership interests, family aggregation rules apply. These family aggregation rules may affect the treatment of stock owned directly or indirectly by family members. The law treats 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, each of these individuals is an HCE for the plan year. It is important to identify the family ownership interests of all company stock and to forward that information to the TPA, advisor or persons performing the nondiscrimination tests.

[Return to Table](#)

### **How to Find the Mistake:**

Complete an independent review to determine if you properly classified HCEs and NHCEs for the ADP and ACP nondiscrimination tests. Plan administrators should pay special attention to:

- Prior year compensation.
- The attribution rules related to ownership when identifying 5% owners.
  - TPAs 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, which may warrant further review for proper attribution.

Also, review the rules and definitions in your plan document for:

- Properly determining HCEs.
- Compensation.
- ADP testing.
- ACP testing.
- Prior or current year testing.

Determine if you have properly identified each employee as an HCE or NHCE. HCEs or NHCEs include all employees eligible to make an elective deferral, even if they chose not to make one for the plan year.

[Return to Table](#)

### **How to Fix the Mistake:**

#### **Corrective Action:**

If a plan fails to satisfy the ADP and/or ACP test and you do not timely correct the mistake, it may result in plan disqualification. If the data used for the original testing is incorrect, then you may have to rerun the ADP and/or ACP tests. If the original or corrected test fails, then corrective action is required in order to rectify the excess contributions made to the HCEs.

- By regulations, you must take corrective action described in the plan document within 12 months following the end of the plan year to which the excess contributions (ADP) or excess aggregate contributions (ACP) relate. If you do this, you do not need EPCRS.

- If 12 months have elapsed since the close of the plan year, you may pursue corrective action through EPCRS.

There are two different methods of correcting ADP and ACP testing mistakes. You may choose whichever method you prefer. Both require a contribution to the plan for NHCEs.

- Method 1 - Under EPCRS, Appendix A, section .03 of Rev. Proc. 2008-50, the permitted correction method is to:
  - Determine the amount necessary to raise the ADP or ACP of the NHCEs to the percentage needed to pass the tests.
  - Make qualified nonelective contributions (QNECs) for the NHCEs to the extent necessary to pass the tests. A QNEC is an employer contribution that is always 100% vested.
    - You must make QNECs for all eligible NHCEs (as long as the contribution does not cause the Code §415 limit to be exceeded). The 415 limit refers to a limit on annual additions that may be credited to a participant's account in a given year. Annual additions consist of employer contributions, forfeitures and employee contributions.
    - These contributions must be the same percentage for each participant.
- Method 2 - Under EPCRS, Appendix B, section 2.01, an alternative permitted correction method is referred to as the one-to-one method.
  - Excess contribution amounts (adjusted for earnings) are assigned and distributed to the HCEs.
  - Any forfeited amounts due to matching contributions are to be used in accordance with the plan document provisions relating to forfeiture.
  - That same dollar amount (in other words, the excess contribution amount, adjusted for earnings) is contributed (in the form of a QNEC) to the plan and allocated prorata, based on compensation, to all eligible NHCEs.

**Example:**

Employer G maintains a profit-sharing plan with a 401(k) feature for its employees. During 2010, the employer performed a review of the plan's operations for the 2008 plan year. During this review, the employer 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%; therefore, the plan failed the ADP test. There were no matching or other employee contributions for the 2008 plan year. The plan has 21 participants.

[Return to Table](#)

**Correction Program(s) Available:**

**SCP:**

EPCRS defines this as an operational error. G determined that the plan had established practices and procedures designed to keep the plan compliant and that the mistake was not significant. Correction could involve one of two methods:

- G could make QNECs to the NHCEs in the amount necessary 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.
  - These contributions must be made for each eligible NHCE (as long as the contribution does not 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.
  - This total amount is distributed to the HCEs.
- An amount equal to the distributed amount is contributed to the plan and allocated prorata, 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, as it pertains to 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 correction of the ADP/ACP mistake could occur under the regulations. The mistake occurred in 2008, with the regulatory correction period ending in 2010, so the correction period under SCP ends on the last day of the 2010 plan year for significant mistakes.

### **VCP:**

If G determined the mistake was not 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 application. Based on the number of participants in our example, 21, G would pay a fee of \$1,000.

### **Audit CAP:**

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, taking into account many factors, including the extent to which correction occurred before audit. Sanctions under Audit CAP are a negotiated percentage of the [Maximum Payment Amount \(MPA\)](#).

### **[Return to Table](#)**

### **How to Avoid the Mistake:**

One way to avoid this type of mistake is by establishing a safe harbor 401(k) plan or 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 is not required to perform the ADP and ACP tests, if it meets certain requirements.

Problems typically result when there is a communication gap between the employer and plan administrator with respect to what the plan document provides and what documentation is needed to ensure compliance. There are several main areas where these communication problems may occur:

- Counting all eligible employees in testing:
  - Share information with the TPA on all employees eligible to make an elective deferral.
  - This would include an eligible employee who terminated voluntarily or involuntarily during the year.
- Share information regarding any related companies with common ownership interests with the TPA.
  - Your plan may require these employees to be eligible to participate in the plan, and therefore included in the various tests.
- Definition of compensation:
  - Be familiar with the terms of the plan document to ensure 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 forwarded to the TPA do not meet the plan definitions, the ADP and ACP tests will be inaccurate and provide false results.
- Identification of HCEs - An important aspect of performing the ADP and ACP tests is properly identifying HCEs.

In summary, you should ensure that you are familiar with the terms of the plan, and you provide your TPA (if you have one) with all of the information needed to make a proper determination of each employee's status.

If either the ADP or ACP test fails, then in order to avoid having to correct under EPCRS or face this issue on audit, you should implement procedures to ensure that you correct excess contributions and/or excess aggregate contributions in a timely manner. Excess contributions result from plans that fail to satisfy the ADP test. They are the amounts that you should distribute 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 in the same manner as excess contributions. However, if the excess aggregate contributions consist of matching contributions that are not fully vested, then reallocate the unvested portion to the accounts of the other plan participants or place them in an unallocated suspense account to use to reduce future contributions.

[Return to Table](#)

--Trends	-Tips-			
Potential Mistake	How to Find the Mistake	How to Fix the Mistake		How to Avoid the Mistake
		Corrective Action	Correction Program(s) Available	
6) Were all eligible employees identified and given the opportunity to make an elective deferral election (exclusion of eligible employees)? <a href="#">(More)</a>	Review plan document sections on eligibility and participation. Check with plan administrators to find out when employees are entering the plan. <a href="#">(More)</a>	EPCRS 6.02(7), Appendix A (section .05), Appendix B (section 2.02) Employer must make a qualified nonelective contribution (QNEC) to the plan on behalf of the employee that compensates for the missed deferral opportunity. <a href="#">(More)</a>	SCP* VCP Audit CAP <a href="#">(More)</a>	Monitor census information and apply participation requirements. <a href="#">(More)</a>

**6) Were all eligible employees identified and given the opportunity to make an elective deferral election (exclusion of eligible employees)?**

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

Generally, under a 401(k) plan, you should treat each employee who receives a Form W-2 as an eligible employee unless you can properly exclude him or her by the plan’s terms. Using the plan’s definition of eligible employee along with the plan’s age and service requirements, you should make a determination of eligibility of each employee receiving a Form W-2. That can be a simple process; however, if you use leased employees, contract labor or have shared ownership of other enterprises determining eligible employees can be more complicated.

A retirement plan does not qualify for tax-preferential treatment unless it meets certain standards. A plan must meet the eligibility and participation standards in order for it to maintain tax-favored treatment. These general rules are:

- A plan may not require an employee to be older than 21 in order to participate in a plan, and
- There are two ways to credit service to an employee, which are:
  - hours of service measured in the context of a year of service (this is the more common method) and
  - periods of employment, commonly referred to as the elapsed time method.
- **Hours of service:** A 401(k) plan may not require more than a year of service as a condition of becoming a participant in the plan.
  - A year of service means a calendar year, a 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.

- An eligible employee meeting these requirements must enter the plan at the beginning of the next plan year, or 6 months after satisfying any eligibility requirements under the plan, if earlier.
- The plan document may impose rules that are more liberal by allowing a younger age and lesser service requirement.
  - For example, a plan may allow a person to participate immediately upon becoming an employee.
- **Elapsed time method:** Under the elapsed time method, an employee's eligibility to participate is not based upon the completion of a specified number of hours of service during a 12-consecutive-month period. Instead, it is determined generally with reference to the total period of time that elapses while the employee is employed.
- Your plan document contains the definitions and requirements for becoming a participant in the plan.

In addition to identifying eligible employees, you must also give them the opportunity to make a salary deferral election. You should have procedures in place to notify these employees of their eligibility and how and when they may participate.

[Return to Table](#)

### **How to Find the Mistake:**

Review your plan document sections concerning eligibility and participation. Check when employees are entering the plan. Treat each employee who received a W-2 during the year as an eligible employee.

- Make a list of all employees who received a W-2.
- Compare their dates of hire, dates of birth, dates of 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 participant in the plan (plan entry date) according to the plan document.
- Inspect payroll and plan records to make certain the employees timely entered the plan and that you gave them the opportunity to make a salary deferral election.

[Return to Table](#)

### **How to Fix the Mistake:**

#### **Corrective Action:**

Generally, if you did not provide an employee the opportunity to make elective deferrals to a 401(k) plan, you must make a qualified nonelective contribution (QNEC) to the plan for the employee that compensates for the missed deferral opportunity. The corrective QNEC is an employer contribution that is intended to replace the lost opportunity to a participant because of not being permitted to make elective deferrals.

The amount of the QNEC is equal to **50%** of the employee's missed deferral. The missed deferral is determined by multiplying the actual deferral percentage (ADP) 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 the calendar year as its plan year. The plan has a one year of service eligibility requirement and provides for January 1 and July 1 entry dates. Jack, who Employer D should have provided the opportunity to make

elective deferrals on January 1, 2008, was not provided the opportunity until January 1, 2009. Jack was a NHCE with compensation for 2008 of \$80,000. The ADP for HCEs for 2008 was 10%. The ADP for NHCEs for 2008 was 8%. Employer D discovers this mistake during a review of the plan in 2009.

Employer D must make a corrective contribution for the 2008 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, 2008). 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). Accordingly, Employer D is required to make a corrective contribution of \$3,200 for Jack. D must adjust this corrective contribution of \$3,200 for earnings through the date of correction.

[Return to Table](#)

### **Correction Program(s) Available:**

#### **SCP:**

The example illustrates an operational problem, in that the employer failed to follow the terms of the plan by failing to give Jack the opportunity to participate in the plan for the 2008 plan year. Therefore, 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, 2010.
  - If not corrected by December 31, 2010, Employer D is not eligible for SCP and must correct under VCP. Even if Employer D makes correction by December 31, 2010, it may only use SCP if the other requirements of SCP are satisfied.

If the mistakes are **insignificant** in the aggregate, Employer D can correct beyond the two-year correction period for significant errors. Whether or not a mistake is insignificant is dependent on all the facts and circumstances.

#### **VCP:**

Under VCP, correction is the same as described, above, under SCP. Employer D makes a VCP submission in accordance with Rev. Proc. 2008-50. The fee for the VCP submission is \$750 (per the [table](#) in section 12.02 of Rev. Proc. 2008-50).

#### **Audit CAP:**

Under Audit CAP, correction is the same as described, above, 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 \(MPA\)](#).

[Return to Table](#)

### **How to Avoid the Mistake:**

Review your plan document and inspect your payroll records to extract 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 (compare the employees on these records with the payroll records) to see if employee counts are accurate.

[Return to Table](#)

--Trends	-Tips-			
Potential Mistake	How to Find the Mistake	How to Fix the Mistake		How to Avoid the Mistake
		Corrective Action	Correction Program(s) Available	
7) Are elective deferrals limited to the amounts under IRC §402(g) for the calendar year and have any excess deferrals been distributed? <a href="#">(More)</a>	Inspect deferral amounts for plan participants to ensure that the employee has not exceeded the limits. <a href="#">(More)</a>	EPCRS Appendix A (section .04) Distribute excess deferrals. <a href="#">(More)</a>	SCP* VCP Audit CAP <a href="#">(More)</a>	Work with plan administrators to ensure that they have sufficient payroll information to verify the deferral limitations of §402(g) were satisfied. <a href="#">(More)</a>

## 7) Are elective deferrals limited to the amounts under IRC §402(g) for the calendar year and have any excess deferrals been distributed?

Code §402(g) places a limit on the amount of elective deferrals a plan participant may exclude from taxable income each calendar year. Code §401(a)(30) provides that in order 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 limitation on elective deferrals provided in §402(g). The limits on elective deferrals under §402(g) are:

- 2005 - \$14,000
- 2006 - \$15,000
- 2007 - \$15,500
- 2008 - \$15,500
- 2009 - \$16,500
- 2010 - \$16,500
- This limit is subject to cost-of-living increases after 2010. (For 2004 and prior years, please 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 from those in a traditional or safe harbor 401(k) plan.

- SIMPLE 401(k) deferrals are limited to \$10,500 for 2009 and 2010.
- This limit is subject to [cost-of-living](#) increases after 2010.

**Catch-up contributions:** A plan may permit participants who are age 50 or over at the end of the calendar year to make additional elective deferrals. These additional contributions (commonly referred to as catch-up contributions) are not subject to the general limits that apply to 401(k) plans. An employer is not required to provide for catch-up contributions in any of its plans. However, if your plan does allow catch-up contributions, it must allow **all** eligible participants to make the same election with respect to 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 for 2009 and 2010.
  - The limit is subject to [cost-of-living](#) increases after 2010.
- If an employee participates in a SIMPLE 401(k) plan and is age 50 or older:

- The elective deferral limit increases by \$2,500 for 2009 and 2010.
- The limit is subject to [cost-of-living](#) increases after 2010.
- The catch-up contribution for a year cannot exceed the lesser of the following amounts:
  - The catch-up contribution limit above, or
  - The excess of the employee's compensation over the elective deferrals that are not catch-up contributions.

Catch-up contributions are **not** subject to the §401(a)(30) plan qualification rule referred to above. The maximum limits for catch-up contributions are found in §414(v) of the Code.

Elective deferrals include both pre-tax elective 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 disqualified.

General rules for 401(k) plans provide for the dollar limits described above; however, the amount a plan participant is entitled to defer is also subject to other limits as described in your plan document. For example, your plan document may place its own, lower limit on the amount of the deferral or on the percentage of pay that participants may defer. Additionally, your plan may need to further limit a plan participant's elective deferrals in order to meet certain nondiscrimination requirements.

If the total of a plan participant's elective deferrals is more than the limit under Code §402(g), to avoid failing Code §401(a)(30), the excess amount plus allocable earnings must be distributed to the participant by April 15 of the year following the year in which the excess occurred. Excess deferrals not timely returned to the participant are subject to additional taxation. Following is a discussion of the tax consequences of excess deferrals.

**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 are distributed.
- There is no 10% early distribution tax, no 20% withholding and no spousal consent requirement on amounts timely distributed.

**Consequences of an untimely distribution.**

- Under Code §401(a)(30), if the excess deferrals arise under one or more plans of the employer and these excess deferrals are not 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 are taxed both in the year contributed to the plan and in the year distributed from the plan.
- These late distributions could be subject to the 10% early distribution tax, 20% withholding and spousal consent requirements.

Excess deferrals distributed to HCEs are included in the ADP test in the year such amounts were deferred. Excess deferrals distributed to NHCEs are not included in the ADP test as long as all deferrals were made under a plan or plans of one employer. Excess deferrals not timely distributed by April 15 are included in annual additions for the year deferred.

[Return to Table](#)

### How to Find the Mistake:

You need to ensure that the §402(g) limit for an applicable year is not exceeded by any participant. The amount of elective deferrals should be compared to the §402(g) limit. If the §402(g) limit is surpassed by any participant during the year and not corrected, there could be a violation of Code §401(a)(30), which could cause your plan to become disqualified.

[Return to Table](#)

### How to Fix the Mistake:

Code §72(t) imposes a 10% additional tax for taxable distributions that do not meet one of the exceptions provided for under the Code, such as death, disability or attainment of age 59 ½, among others. In order to avoid the tax under §72(t), a §401(a)(30) mistake should be corrected no later than the first April 15 following the close of the year. If the plan sponsor does not make correction timely, it may still correct this mistake under EPCRS; however, making the correction under EPCRS will not prevent the payment of any §72(t) tax resulting from the mistake.

- Under EPCRS, Appendix A, section .04, of Rev. Proc. 2008-50, 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 as provided by the Code and regulations under §402(g). These amounts are reported on Form 1099-R.

Distributions of excess deferrals made after April 15 to an HCE are included in the ADP test for the year of deferral. Distributions to a NHCE are not included in the ADP test.

### Example:

Employer X maintains a profit-sharing plan with a §401(k) feature. There are 21 participants in the plan. For calendar year 2008, Ann defers \$16,500 to the plan. Ann is under age 50 and thus is not eligible to make catch-up contributions. Ann has excess deferrals of \$1,000 because \$15,500 is the §402(g) maximum amount permitted for 2008 (\$16,500 - \$15,500 = \$1,000). Employer X does not discover this mistake until after April 15, 2009. On November 1, 2009, X distributes the excess deferral (plus applicable earnings of \$100, totaling \$1,100) to Ann.

For 2008 (year of deferral), Ann must include **\$1,000** in gross income. For 2009 (year of distribution), Ann must include **\$1,100** in gross income. This amount would be shown on a Form 1099-R and Ann must also pay the §72(t) tax.

[Return to Table](#)

### Correction Program(s) Available:

#### SCP:

The example illustrates an operational problem, in that the employer failed to follow the terms of the plan that prohibit the elective deferrals of any employee from exceeding the §401(a)(30) limit. Therefore, 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, 2010.

- If not corrected by December 31, 2010, Employer X is not eligible for SCP and must correct under VCP. Even if Employer X makes correction by December 31, 2010, X may only use SCP provided the other requirements of SCP are satisfied.
- If the mistakes are **insignificant** in the aggregate, Employer X can correct beyond the two-year correction period for significant errors. Whether or not a mistake is insignificant is dependent on all the facts and circumstances.

**VCP:**

Under VCP, correction is the same as described, above, under SCP. Employer X makes a VCP submission in accordance with Rev. Proc. 2008-50. The fee for the VCP submission is \$1,000 (per the [table](#) in section 12.02 of Rev. Proc. 2008-50).

**Audit CAP:**

Under Audit CAP, correction is the same as described, above, 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 \(MPA\)](#).

[Return to Table](#)

**How to Avoid the Mistake:**

You should work with your plan administrator to ensure the administrator has sufficient payroll information to verify that the deferral limitations of §402(g) were satisfied. You should have procedures in place to ensure that, based on the participant election forms (including modifications), participants will not exceed the §402(g) limit. Also, you should have checks and balances in place to alert you and your TPA when a participant does exceed the limit so you can take corrective action on a timely basis.

[Return to Table](#)

--Trends	-Tips-			
Potential Mistake	How to Find the Mistake	How to Fix the Mistake		How to Avoid the Mistake
		Corrective Action	Correction Program(s) Available	
8) Have you timely deposited employee elective deferrals? <a href="#">(More)</a>	Determine the earliest date you can segregate deferrals from general assets; compare that date with the actual deposit dates and any plan document requirements. <a href="#">(More)</a>	Usually DOL through VFCP for prohibited transaction. May also be EPCRS.  For both VFCP and EPCRS, deposit into the plan's trust all elective deferrals withheld and applicable earnings resulting from the late deposit of amounts to the trust. <a href="#">(More)</a>	SCP* VCP Audit CAP <a href="#">(More)</a>	Coordinate closely with 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.  <a href="#">(More)</a>

**8) Have you timely deposited employee elective deferrals?**

The employer is responsible for contributing to the trust the amounts of the elective deferrals made by plan participants. To the extent your plan document contains language regarding the timing of deposits of elective deferrals, you may correct failures to follow the terms of the plan document under EPCRS. However, this type of mistake can also lead to another problem – it may give rise to a “prohibited transaction.” A prohibited transaction is a transaction between a plan and a disqualified person that the law prohibits. An employer is considered a disqualified person.

Prohibited transactions generally include the following transactions:

- a transfer of plan income or assets to, or use of them, by, or for the benefit of, a disqualified person;
- any act of a fiduciary by which plan income or assets are used for his or her own interest;
- the receipt of consideration by a fiduciary, for his or her own account, from any party dealing with the plan in a transaction that involves plan income or assets;
- the sale, exchange or lease of property between a plan and a disqualified person;
- lending money or extending credit between a plan and a disqualified person; and
- furnishing goods, services or facilities between a plan and a disqualified person.

A prohibited transaction gives rise to an excise tax. A disqualified person who takes part in a prohibited transaction must correct the transaction and must 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 (or part of a year) in the taxable period. If the disqualified person does not correct the transaction within the taxable period, the law imposes an additional tax of 100% of the amount involved.

Department of Labor rules require that the employer make elective deferrals to the trust on the earliest date that the employer can reasonably segregate the amount from the employer's general assets; however, in no event can the employer deposit the amount later than the 15<sup>th</sup> business day of the following month. Keep in mind that the rules regarding the 15<sup>th</sup> business day of the following month do not provide a safe harbor for depositing deferrals; rather, it sets the

maximum deadline for deposit. DOL recently finalized a [7-business day safe harbor rule](#) for employee contributions to plans with fewer than 100 participants.

If the employer does not 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, correction of a prohibited transaction is not one of the correctable mistakes under EPCRS. However, the Department of Labor's Employee Benefits Security Administration maintains a [Voluntary Fiduciary Correction Program \(VFCP\)](#), which may be able to resolve the prohibited transaction.

Rules governing the timing of matching contributions or other employer contributions are different from those for elective deferrals. The employer must meet the following rules in order to obtain a current tax deduction. Contributions made by the employer to match part or all of the participant's elective deferral may be made at the time of the elective deferral contribution or later, but in no event later than the due date of the employer's income tax return, including extensions. A 401(k) plan may have other employer contributions. Employer contributions that are not tied to elective deferrals must be made no later than the due date of the employer's tax return, including extensions. Review your plan document for the timing and amount of your matching contributions and other employer contributions.

[Return to Table](#)

#### **How to Find the Mistake:**

You should review plan terms relating to the timely deposit of elective deferrals and determine if you have followed them. Although it is not 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 (coincident with payroll), but deposit(s) are made on a biweekly basis, you may have an operational mistake requiring correction under EPCRS. In this simple example, your mistake would be not operating the plan in accordance with the plan document, which is correctable under EPCRS.

[Return to Table](#)

#### **How to Fix the Mistake:**

##### **Corrective Action:**

Correction through EPCRS may be required if the terms of the plan were not 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 into the trust, along with lost earnings.
- 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 participants in the plan. 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 2008 plan year.

[Return to Table](#)

### **Correction Program(s) Available:**

Employer B did not make the deposits within the time required by the plan document. This operational mistake is correctible under EPCRS.

#### **SCP:**

The example illustrates an operational problem, in that the employer failed to follow the terms of the plan relating to the timing for depositing elective deferrals. Therefore, 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, 2010.
  - If not corrected by December 31, 2010, Employer B is not eligible for SCP and must correct under VCP. Even if B makes correction by December 31, 2010, it may only use SCP if the other requirements of SCP are satisfied.
- If the mistakes are **insignificant** in the aggregate, Employer B can correct beyond the two-year correction period for significant errors. Whether or not a mistake is insignificant is dependent on all the facts and circumstances.

#### **VCP:**

Under VCP, correction is the same as described, above, under SCP. Employer B makes a VCP submission in accordance with Rev. Proc. 2008-50. The fee for the VCP submission is \$15,000 (per the [table](#) in section 12.02 of Rev. Proc. 2008-50).

#### **Audit CAP:**

Under Audit CAP, correction is the same as described, above, under SCP. Employer B and the IRS enter into a closing agreement outlining the corrective action and negotiate a sanction based on the [Maximum Payment Amount \(MPA\)](#).

[Return to Table](#)

### **How to Avoid the Mistake:**

Establish a procedure whereby you deposit elective deferrals coincident with or after each payroll in accordance with the plan document. If you have instances where your deferral deposits are a week or two later than the normal timely deposit (due to vacations or other disruptions, for example), 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, dealing with this issue. If you have a change in the person in charge of making these deposits, make certain the new person has a full understanding of when he or she must make these deposits.

[Return to Table](#)

--Trends	-Tips-			
Potential Mistake	How to Find the Mistake	How to Fix the Mistake		How to Avoid the Mistake
		Corrective Action	Correction Program(s) Available	
9) Do participant loans conform to the requirements of the plan document and IRC §72(p)? <a href="#">(More)</a>	Review the plan document and all outstanding loans to ensure the loans comply with the plan's terms and that the employees are repaying their loans timely. <a href="#">(More)</a>	EPCRS 6.07, Appendix F (Schedule 5) Some failures may be corrected by corrective repayment and/or modification of loan terms. <a href="#">(More)</a>	VCP Audit CAP <a href="#">(More)</a>	Review and follow the plan provisions relating to making loans, including the amount of loan, term of the loan and repayment terms. Make sure there are procedures in place to prevent loans that are prohibited transactions. <a href="#">(More)</a>

**9) a) Do participant loans conform to the requirements of the plan document and IRC §72(p)?**

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

A loan to a participant must meet a number of rules under Code §72(p) to prevent the law from treating it as a taxable distribution to the participant. The rules are:

- 1) The plan must base the loan on a legally enforceable agreement.
  - a. The agreement can be a paper or electronic written document that states the date and amount of the loan and binds the participant to a repayment schedule that would ensure he or she repays the loan.
  - b. The participant must adequately secure the loan and the terms of the loan, including the interest rate and repayment schedule, should be similar to what a participant might be able to receive from a financial institution.
- 2) The amount of the loan cannot exceed the lesser of 50% of the participant's vested account balance or \$50,000.
  - a. An exception allows a participant to borrow up to \$10,000, even if it exceeds 50% of his or her vested account balance.
  - b. If the participant previously took out another loan, then the plan sponsor must reduce the \$50,000 limit of the new loan by the highest amount owed by the participant on other participant loans during the one-year period ending on the day before the new loan.
- 3) The terms of the loan should require the participant to make level amortized repayments at least quarterly.
  - a. Each payment should include an allocation of principal and interest.
  - b. The participant must fully repay the loan within five years from the date of the loan, unless the participant uses the loan amount to purchase his or her main home.
- 4) Special exception:

- a. Leave of absence.
  - i. A plan may permit a participant to suspend repayments for no longer than a year while he/she is on a leave of absence.
  - ii. The plan administrator may not extend the loan's maximum repayment period.
  - iii. Upon return from leave of absence, the participant will be required to make additional payments on the loan in order to ensure that he or she fully repays it within the five-year-period by either:
    1. increasing the installment amounts owed over the remaining period of the loan, or
    2. keeping the installment amounts the same, but making a catch up payment for the missed installments that occurred 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.

### [Return to Table](#)

#### **How to Find the Mistake:**

The plan sponsor should review the loan agreements and loan repayments to verify the loans have met the rules to keep them 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 it meets the rules required to exempt it from treatment as a taxable distribution, including the following:
  - Are participants required to repay their loans within 5 years?
    - For a loan in excess of 5 years, is there documentation in the file that would show that the employee used the loan to purchase a primary residence?
  - Is the interest rate on each loan reasonable? The interest rate charged for a loan cannot be more favorable than what the participant would expect to get from a financial institution for a similarly secured loan.
  - Was the amount of the loan less than the applicable dollar limit? In order to address this question, one would need to know the participant's vested account balance as of the date of the loan and whether the participant had taken out loans prior to the date of the loan under review.
  - Does the repayment schedule require the participant to make level repayments at least as frequently as quarterly? Are the payment amounts properly calculated?
- Ensuring that, for each loan, loan payments to the plan are timely made in accordance with the loan's 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. The plan sponsor should pay particular attention to this issue if it changes payroll systems or providers.

### [Return to Table](#)

#### **How to Fix the Mistake:**

### **Corrective Action:**

It is important that plans have a system in place to ensure that a participant loan's terms and its actual repayments follow the law so the loan is exempt from treatment as a taxable distribution. Generally, once a loan violates a rule, the participant cannot correct it to save that exemption. There are a few circumstances where the plan administrator can make correction and preserve the exemption:

- The plan administrator may allow for a "cure period" that would allow a participant to make up for a missed payment. The cure period cannot go beyond the end of the calendar quarter following the calendar quarter in which the missed payment was due.
- If the loan violated the terms of the plan document and/or the rules of Code §72(p), the plan sponsor has two choices. It may be able to use the Voluntary Correction Program to permit employees to take into income the amount of the loan in the year of correction (as opposed to the year in which the problem occurred), or, it may be able to request relief from reporting the loans as taxable distributions to participants from the IRS under its VCP. Generally, in order for a plan loan to be eligible for relief from income tax reporting under VCP:
  - employer action caused the participant's failure to pay back 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, reform the loan to amortize the remaining principal balance as of the date of repayment over the remaining period of the original loan. The corrective payment for the excess loan amount depends on: (1) the amount of the excess as of the date of the loan, (2) the payments previously made on the loan and (3) the portion of the previously made payments that were allocated to the excess loan amount.

There are three alternative methods that may be used to determine the allocation of prior repayments toward the excess loan amount and the corrective payment required to repay the excess loan amount. They are:

- Method 1: Prior repayments are applied to reduce the portion of the loan that did not exceed the limit. This means that 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 thereon; or
  - Method 2: Prior repayments are used to pay the interest on the portion of the loan in excess of the limit, with the remainder of the repayments used to reduce the portion of the loan that did not exceed the limit. The corrective payment for the excess loan amount is equal to the original excess loan amount; or
  - Method 3: Prior repayments are applied against the loan excess and the maximum loan amount permitted under §72(p) 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 §72(p) (5 years) from the original date of the loan.
  - **Loan that is 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 balance of the loan, 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 formal loan program for its participants. AZCorp has 50 employees, three of which had participant loans. AZCorp conducted a year-end review of its loan program and uncovered the following issues:

- Bob received a loan from the plan on May 1, 2008. The loan was for \$60,000 over a five-year term amortized monthly using a reasonable interest rate. Bob made the required payments on the loan on time. The loan amount is less than 50% of Bob's vested account balance. However, the loan amount exceeds the maximum limit of \$50,000 provided under Code §72(p).
- Terri received a loan of \$10,000, dated April 1, 2008, over a six-year period. Payments are timely and the interest rate is reasonable. The term of the loan exceeds the maximum 5 year repayment period allowed under Code §72(p).
- Dean borrowed \$10,000, dated March 1, 2008, over a five-year period. Due to a payroll error, AZCorp failed to withhold the required loan repayments from Dean's pay since August 1, 2008. 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, 2009.

[Return to Table](#)

**Corrective Action:**

**Bob** – Loan amount in excess of the \$50,000 limit - AZCorp decided to correct this mistake by requiring a corrective repayment to the plan due to the \$10,000 loan excess, in accordance with Method 3 in the discussion, above, related to loans that exceed the dollar limit. Since Bob has already repaid some of the loan, these repaid amounts may be taken into account in determining the amount of the required corrective repayment (see alternative methods for allocating prior repayments to the original excess loan amount). AZCorp applied Bob's prior repayments on a pro-rata basis between the \$10,000 loan excess and the \$50,000 maximum amount of the loan permitted under §72(p) (see Method 3 for allocating prior repayments). Therefore, Bob's corrective repayment equaled the balance remaining on the \$10,000 loan excess as of February 1, 2009, the date of correction.

**Terri** – Loan term in excess of the five-year limit - AZCorp is correcting this mistake by reamortizing the loan balance over the maximum remaining period allowed under §72(p) (5 years) from the original loan date. On February 1, 2009, AZCorp reamortized the balance of the loan for Terri so that it will be fully repaid by April 1, 2013 (five years from the date of the original loan).

**Dean** – Loan payments not made - The loan went into default as of November 2, 2008, upon the expiration of the plan's stated cure period of three months. It was determined the employer was partially at fault due to its failure to continue collecting loan repayments. AZCorp decided to correct 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 period of the loan.

[Return to Table](#)

## **Correction Program(s) Available:**

### **SCP:**

This type of mistake may not be corrected under SCP. In order to obtain relief, this mistake must be corrected under VCP.

### **VCP:**

Employer AZCorp makes a VCP submission in accordance with Rev. Proc. 2008-50. The fee for the VCP submission is generally based on the number of plan participants (per the [table](#) in Sec. 12.02 of Rev. Proc. 2008-50). However, the revenue procedure provides for a fee reduction of 50% where the loan failure is the only failure of the submission and no more than one quarter of the participants are affected by errors in participant loans. 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%).

### **Audit CAP:**

Under Audit CAP, correction is the same as described above under "Reasonable Correction." Employer AZCorp and the IRS enter into a closing agreement outlining the corrective action and negotiate a sanction based on the [Maximum Payment Amount \(MPA\)](#).

[Return to Table](#)

## **How to Avoid the Mistake:**

The plan sponsor should develop loan procedures, including:

- A system for determining the maximum loan amount for a participant in the process for approving a loan request. The participant's account balance and prior loan history should be readily available to the individual(s) responsible for ensuring that they make the loan within the limits.
- A written policy for determining the terms of the loan (for example, the criteria used for determining the loan's interest rate).
- Written, enforceable loan agreements. The plan should not 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 it 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 any form that a participant completes to request a loan.
- Procedures for monitoring timely repayment. Many plans require loan repayment by payroll deduction. In order for the process to work, the payroll service provider must know to withhold the loan repayments and needs enough information to determine the correct amount to withhold. In addition, the payroll system needs to be able to deposit the amounts withheld to the plan timely.
- Procedures for analyzing deposits. Procedures for the plan's record keeper to allocate the appropriate amounts to the participants' loan balances.
- Software/tools. Accurate software (or other tools) used to determine loan limits and repayment amounts.

[Return to Table](#)

## **9b) Did the plan make loans to individuals who are disqualified persons? If yes, are the loans prohibited transactions under § 4975 of the Code?**

Prohibited transactions under Code §4975 are generally any direct or indirect transfer to, or use by or for the benefit of, a [disqualified person](#), of a plan's income or assets. Therefore, a loan from the plan to a disqualified person may be a prohibited transaction unless specific requirements are met. 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 Code §4975.

Loans to disqualified persons must meet certain requirements to avoid being a prohibited transaction. 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 use of the plan's money by the disqualified person. The tax is payable by the disqualified person.

For the law not to consider a loan a prohibited transaction, the loan must be:

- made available to all participants or beneficiaries on a reasonably equivalent basis,
- made available to highly compensated employees in an amount no greater than the amount made available to other employees,
- made in accordance with specific provisions stated in the plan,
- bear a reasonable rate of interest, and
- be adequately secured.

### **How to Find the Mistake:**

In order to determine if participant loans are prohibited transactions, you need to review the loan agreements and loan repayments, including:

- 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 on a reasonably equivalent basis. (Note: if the plan does not 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 loans from the plan. (Note: Loans made to individuals who are not disqualified persons are not prohibited transactions under §4975.)
- 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 if -
  - a. the loan was based on a reasonable interest rate (for example, a rate similar to what the participant would have been able to obtain had a similar loan been taken from a financial institution); and
  - b. the loan was 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 and/or that are not adequately secured are prohibited transactions.

- 5) Review the disqualified person's actual loan payments to determine if he or she is following the loan document's terms. The law treats amounts not timely paid according to the loan's 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 pay back all amounts outstanding on the loan (principal and interest) to the plan. Excise taxes under §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 Program(s) Available:**

The IRS does not have a correction program that provides relief from the excise taxes owed under Code §4975. The disqualified person must pay all excise taxes owed with respect to the prohibited transaction.

### **How to Avoid the Mistake:**

- Before making a loan to a participant (including a disqualified person), make sure that the plan document provides for loans and that the loan complies with the plan's terms.
- The plan should establish a loan policy that is consistent with the plan's terms and 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 the payments made by the disqualified person to ensure that he or she makes the payments according to the loan's terms.

### **9c) Are there any other correction programs that may apply to transactions involving loans that were not made in accordance with the plan's terms?**

Yes, some loan transactions may also result in fiduciary violations under Title I of the Employee Retirement Income Security Act (ERISA). The Department of Labor has established the [Voluntary Fiduciary Correction Program](#) to enable correction of some fiduciary violations. For details, please visit the [DOL's Web site](#).

[Return to Table](#)

--Trends	-Tips-			
Potential Mistake	How to Find the Mistake	How to Fix the Mistake		How to Avoid the Mistake
		Corrective Action	Correction Program(s) Available	
10) Were hardship distributions made properly? <a href="#">(More)</a>	Review all in-service distributions and determine that hardship distributions met the plan requirements. <a href="#">(More)</a>	EPCRS Appendix B (section 2.07). Amend plan retroactively to allow for hardship distributions. If impermissible hardship distribution, have participant return hardship distribution amount plus earnings. <a href="#">(More)</a>	SCP* VCP Audit CAP <a href="#">(More)</a>	Be familiar with your plan document's hardship provisions. Implement procedures to ensure you follow the provisions in operation. Ensure that the plan administrators and payroll offices share the plan's hardship distribution information. <a href="#">(More)</a>

**10) Were hardship distributions 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 do not include any income earned on the deferred amounts. The employee cannot roll over hardship distributions to another plan or IRA. The law treats a distribution as a hardship distribution only if it is made because of the hardship. For purposes of this rule, the employer makes a distribution because of hardship only if the distribution is made both on account of an immediate and heavy financial need of the employee 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 on account of an immediate and heavy financial need of the employee if the distribution is for:

- Expenses for medical care previously incurred by the employee, the employee's spouse, or any dependents of the employee or 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, or the employee's spouse, children or dependents;
- Payments necessary to prevent the eviction of the employee from the employee's principal residence or foreclosure on the mortgage 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 the conditions above for determining whether a distribution is necessary to satisfy an immediate and heavy financial need of the employee. These rules are contained in the regulations under §401(k) and they are designed to relieve the employer (and the employee) from looking to resources outside of the 401(k) plan.

The Pension Protection Act of 2006 modified the deemed hardship rules described, above, to treat a participant's plan beneficiary the same as a participant's spouse and dependents for

purposes of qualifying for a hardship distribution. In other words, a hardship distribution described in the 1<sup>st</sup>, 3<sup>rd</sup> and 5<sup>th</sup> bullets, above, can now be made to a participant based upon the need of a grandchild or domestic partner as long as that individual has been designated as a beneficiary under the plan. While you are not required to modify your plan to include this change, this option is only available if you amended your plan document to include it.

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

- If the distribution is in excess of the amount needed to relieve the financial need of an employee, or
- If the financial need may be satisfied from other resources that are 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, whether as community property, joint tenants, tenants by the entirety, or tenants in common, 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 reasonably anticipated to 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 cannot reasonably be relieved:

- Through reimbursement or compensation by insurance or otherwise;
- By liquidation of the employee's assets;
- By cessation of elective deferrals or employee contributions under the plan; or
- By other distributions or nontaxable (at the time of the loan) 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 cannot 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 cannot reasonably relieve the need for funds to purchase a principal residence if the loan would disqualify the employee from obtaining other necessary financing.

Record keeping is an important area that plan sponsors commonly neglect. 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.

[Return to Table](#)

### **How to Find the Mistake:**

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

Review all distributions made during the year and determine which may have been a hardship distribution. For each of the hardship distributions, make a determination whether each one met the hardship distribution requirements in the plan document. Look for abuse of the hardship feature. Almost anyone can find himself or herself in need of a financial bailout; however, if most of your hardship requests come from a specific group of employees, you may have some participants abusing the plan's hardship feature.

[Return to Table](#)

### **How to Fix the Mistake:**

#### **Corrective Action:**

In our discussion of mistakes involving hardship distributions, we'll focus on mistakes involving plan document issues and distributions not meeting the hardship requirements.

- The plan document does not allow for hardship distributions, but in operation, hardship distributions do occur.
  - Correction may involve a retroactive amendment to allow hardship distributions.
- Hardship distributions are made to participants that don't meet the plan document's hardship requirements or §401(k).
  - Correction may involve a repayment to the plan of the amounts that did not meet the plan's hardship requirements or §401(k).

#### **Example 1:**

Employer L maintains a 401(k) plan with 40 participants. Plan provisions do not allow for hardship distributions. Employer L made hardship distributions to a number of employees during the 2006 and 2007 plan years. During a review of its plan's operations, Employer L determined that it had made these hardship distributions available to all employees and that it had met the standards under the Code for hardship distributions.

[Return to Table](#)

### **Correction Program(s) Available:**

#### **SCP:**

This mistake would be considered an operational error. If L determines it has established practices and procedures in place to promote the overall compliance of their plan, it may correct the plan mistake under SCP. Although, in general, correction of an operational error through an amendment to the plan is not 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, 2006, to provide for the hardship distributions that Employer L made available. The amendment must provide that the hardship distribution option is available in a nondiscriminatory manner.

#### **VCP:**

Employer L may also correct the mistake under VCP by adopting a retroactive plan amendment, effective January 1, 2006, to provide for the hardship distributions it made available. The amendment must provide that the plan make the hardship distribution option available in a nondiscriminatory manner

The fee for a 40-person plan is \$1,000.

**Audit CAP:**

Employer L may also correct this error under Audit CAP. See example 3, below, for a discussion of Audit CAP.

**Example 2:**

Same facts as in Example 1, except Employer L did not make the distributions available to all employees and the only hardship distribution it made was to an HCE.

**Correction Program(s) Available:**

**SCP:**

Since Employer L did not make hardship distributions available to all employees, correction by retroactive amendment under SCP is not available. A correction that is reasonably designed to facilitate overall compliance in accordance with the principles in section 6 of Rev. Proc. 2008-50 will be permitted.

**VCP:**

Employer L may correct the mistake under VCP. However, since Employer L did not make the hardship distributions available to all employees and, in fact, only made them available to select HCEs, EPCRS does not permit a retroactive plan amendment to correct this mistake because it will not satisfy the nondiscrimination rules. A correction that is reasonably designed to facilitate overall compliance in accordance with the principles in section 6 of Rev. Proc. 2008-50 will be permitted.

The fee would be the same as in Example 1 (\$1,000).

**Audit CAP:**

Employer L may also correct this error under Audit CAP. See example 3, below, for a discussion of Audit CAP.

**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 2007 plan year did not have proper documentation. Further investigation by M revealed it did not base five of the distributions on any hardship, but were nothing more than in-service distributions. There were no written procedures in place to review a participant's application for a hardship distribution.

**Correction Program(s) Available:**

**SCP:**

This mistake may not be eligible to correct under SCP since there were not adequate practices and procedures in place with regard to hardship distributions.

**VCP:**

Employer M may correct this mistake under VCP. M must request that the five participants who received distributions that did not meet the hardship requirements of the plan repay the amounts plus earnings to the plan. In addition, M must improve the plan's administrative procedures regarding hardships. Expecting participants to repay these amounts to the plan in full may be problematic because the participants may have already spent the funds. A plan document requiring spousal consents for distributions, plus possible tax issues on the distributions could further complicate the final correction. Correction will depend on all the facts and circumstances

of each individual situation and may include, in some form, paybacks, employer corrective contributions and even some form of plan amendment. If this represents your situation, file a VCP application and work with the Voluntary Correction agent to determine the proper correction.

The fee for a 7,500-person plan is \$20,000.

**Audit CAP:**

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, taking into account many factors, including the extent to which correction occurred before audit. Sanctions under Audit CAP are a negotiated percentage of the [Maximum Payment Amount \(MPA\)](#).

[Return to Table](#)

**How to Avoid the Mistake:**

Administering a hardship distribution program may be complicated, but knowing their 401(k) accounts can be used in times of a financial emergency may make it easier for rank-and-file employees to build their retirement accounts. As with many mistakes, employers with a better understanding of their plan document make fewer mistakes. What follows are a few things you can do to cut down on mistakes in this area:

- Review the language in your plan document to determine when and under what circumstances you can make distributions.
- When you amend your plan document, make certain the language regarding hardship distributions is contained in the most recent document.
- Establish hardship distribution procedures. Work with your benefits professional (if any) to determine if they are sufficient to avoid mistakes.
- Only allow hardship distributions that meet the plan document and Code §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 look 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 have not been properly notified of the availability of hardships.

[Return to Table](#)

--Trends	-Tips-			
Potential Mistake	How to Find the Mistake	How to Fix the Mistake		How to Avoid the Mistake
		Corrective Action	Correction Program(s) Available	
11) If the plan was top-heavy, were the required minimum contributions made to the plan? <a href="#">(More)</a>	Review the rules and definitions for top-heavy found in your plan document. Make a determination whether your plan is top-heavy for each plan year. <a href="#">(More)</a>	EPCRS Appendix A (section .02) Properly contribute and allocate the required top-heavy minimum, adjusted for earnings, to the affected non-key employees. <a href="#">(More)</a>	SCP* VCP Audit CAP <a href="#">(More)</a>	Perform a top-heavy test each year. <a href="#">(More)</a>

### 11) If the plan was top-heavy, were the required minimum contributions made to the plan?

In addition to ADP and ACP tests for 401(k) plans, you should perform other tests annually, such as the tests associated with the top-heavy rules, which 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 preceding plan year, the aggregate value of the plan accounts of key employees (as defined below) exceeds 60% of the aggregate value of the plan accounts for all employees under the plan.

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 an accelerated 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.

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

- An officer whose annual compensation from the employer exceeds [\\$150,000 \(2010\)](#);
- 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 whose compensation exceeds \$150,000 for the plan year.

A non-key employee is any employee who is not a key employee.

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

Remember, when you're determining ownership interests, family aggregation rules apply. These family aggregation 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 are not subject to the top-heavy rules.

[Return to Table](#)

### **How to Find the Mistake:**

Review the top-heavy rules and definitions found in your plan document. Make the determination as to whether your plan is top-heavy for each plan year. Be careful to identify the owners and their family members that are employed by the employer and apply the family aggregation rules.

It is 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 that only covers you and your spouse, and you hire other employees who eventually become eligible under the plan, you probably will have to make required minimum contributions if the new employees are non-key employees.

[Return to Table](#)

### **How to Fix the Mistake:**

#### **Corrective Action:**

Under EPCRS, Appendix A, section .02, the permitted correction method for failure to provide the minimum top-heavy contribution is to:

- Identify the affected employees, and
- Properly contribute and allocate the required top-heavy minimum, adjusted for earnings, to the affected non-key employees.
  - Top-heavy minimums in a 401(k) plan are equal to 3% of compensation. However, if the highest percentage of contribution for a key employee is less than 3%, the top-heavy minimum is equal to that percentage.

#### **Example:**

Employer J, a husband and wife business, have sponsored a 401(k) plan for themselves since 2002. As business expanded, they hired two other employees on July 31, 2005. According to the terms of the plan document, both these new employees became eligible for the 401(k) plan on January 1, 2007. Both new employees made elective deferrals to the plan and it passed the ADP test for both 2007 and 2008. During a review of the plan, Employer J determined the plan was top-heavy for the 2007 and 2008 plan years; however, J did not make minimum top-heavy contributions.

[Return to Table](#)

### **Correction Program(s) Available:**

#### **SCP:**

The example illustrates an operational problem, in that the employer failed to follow the top-heavy provisions of the plan. Therefore, 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 2007 plan year by the end of 2009. J needs to make the corrective contribution for the mistake that occurred in 2008 by December 31, 2010.
  - If Employer J does not make these corrective contributions by the above dates, Employer J is not eligible for SCP and must correct under VCP. Even if J makes correction by December 31, 2010, J may only use SCP if the other SCP requirements are satisfied.
- If the mistakes are **insignificant** in the aggregate, Employer J can correct beyond the two-year correction period for significant errors. Whether a mistake is insignificant is dependent on all the facts and circumstances.

**VCP:**

Under VCP, correction is the same as described, above, under SCP. Employer J makes a VCP submission in accordance with Rev. Proc. 2008-50. The fee for the VCP submission is \$750 (per the [table](#) in section 12.02 of Rev. Proc. 2008-50).

**Audit CAP:**

Under Audit CAP, correction is the same as described, above, under SCP. Employer J and the IRS enter into a closing agreement outlining the corrective action and negotiate a sanction based on the [Maximum Payment Amount \(MPA.\)](#).

[Return to Table](#)

**How to Avoid the Mistake:**

You should perform a top-heavy test each year. Also, you should take care to properly identify ownership interests under the family aggregation rules so that 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](#)

--Trends	-Tips-			
Potential Mistake	How to Find the Mistake	How to Fix the Mistake		How to Avoid the Mistake
		Corrective Action	Correction Program(s) Available	
12) Have you filed a Form 5500 series return and have you distributed a Summary Annual Report (SAR) to all plan participants this year? <a href="#">(More)</a>	Find your signed copy of the return and determine if you filed it timely. <a href="#">(More)</a>	File all delinquent returns. <a href="#">(More)</a>	For Form 5500 filers, see DFVC→ DOL Web site Form 5500-EZ filers must file and ask for abatement of penalties. <a href="#">(More)</a>	Understand your filing requirement and know who filed and when. Don't assume someone is taking care of it for you. <a href="#">(More)</a>  <a href="#">See 401(k) Resource Guide - Plan Sponsors - Filing Requirements</a>

## 12) Have you filed a Form 5500 series return and have you distributed a Summary Annual Report (SAR) to all plan participants this year?

Under ERISA, employers and plan administrators are required to submit reports to government agencies and furnish certain plan information to participants. Plan Sponsors are generally required to file a Form 5500, *Annual Return/Report of Employee Benefit Plan*, each year for an employee benefit plan subject to ERISA. Most employers that sponsor a qualified retirement plan, such as a 401(k) plan, are required to file this return. For an expanded explanation of how to file your Form 5500 return, along with the EFAST electronic filing requirements, please visit [www.efast.dol.gov](http://www.efast.dol.gov).

In addition to the Form 5500, you must make certain other plan information is available to participants. Following is a list of documents that you must make available to participants and beneficiaries:

- Summary Plan Description (SPD) – This plain language explanation of the plan must be comprehensive enough to apprise participants of their rights and responsibilities under the plan. Among other things, the SPD must include information about:
  - When and how employees become eligible to participate.
  - The source of contributions and contribution levels.
  - Vesting – the length of time an employee must be in the plan to receive benefits.
  - How to file a claim for those benefits.
  - Participant's basic rights and responsibilities under ERISA.

You must give this document to your employees after they join the plan and to beneficiaries after they first receive benefits. You must also redistribute SPDs periodically and provide them on request.

- Summary of Material Modification (SMM) – Apprises participants and beneficiaries of changes to the plan or to information required to be in the SPD. You must provide the SMM or an updated SPD to the participants and beneficiaries within 210 days after the end of the plan year in which you adopted the change.
- Summary Annual Report (SAR) – Outlines in narrative form the financial information in the plan's annual report, the Form 5500, and you must furnish it annually to participants.

- Individual Benefit Statement – Provides participants with information about their account balances and vested benefits. Plans must automatically provide statements to participants quarterly for participant-directed plans and annually for plans that do not permit participant direction.
- Blackout Period Notice – For profit-sharing plans with or without a 401(k) feature, at least 30 days (but not more than 60 days) advance notice is required before a plan is temporarily closed for more than 3 consecutive business days to certain participant transactions (directing investments, taking loans or taking distributions). Typically, blackout periods occur when plans change record keepers or investment options, or when plans add participants due to a corporate merger or acquisition.

[Return to Table](#)

### **How to Find the Mistake:**

Many employers identify this mistake when they receive a letter from IRS or DOL stating that the employer did not file the Form 5500 series return. It's normally a year after it was due and includes a substantial fine. Late filed returns are subject to penalties from both IRS and DOL, so it's very important you identify this mistake before we do. Following are the penalties:

- The IRS penalty for late filing of a 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 before we do, find your signed copy of the return, and determine if it you filed it timely.

[Return to Table](#)

### **How to Fix the Mistake:**

Correction of a late filed Form 5500 is not available under EPCRS. If you determine you did not file your Form 5500 series return, the correction is filing the delinquent return. It's very important you file the delinquent return as soon as possible. DOL maintains a [Delinquent Filer Voluntary Correction Program \(DFVC\)](#). However, DFVC is not available for Form 5500-EZ filers.

IRS is responsible for determining any late filer penalty for a Form 5500-EZ.

- Submit a reasonable cause statement with the late Form 5500-EZ explaining why the return was late.
- IRS will review the reasonable cause statement and may reduce or waive the late filer penalty.

### **Example:**

Employer Z sponsors a 401(k) for its employees and failed to file a Form 5500 series return for the 2007 year.

[Return to Table](#)

### **Corrective Action:**

Failing to properly file a Form 5500 return is not correctable under EPCRS. If the IRS reaches out to you regarding a delinquent Form 5500 series return, you may file it in response to the letter. Include an explanation as to why you did not file the return and request a waiver of the penalty. In addition, the Department of Labor has a [Delinquent Filer Voluntary Correction Program \(DFVC\)](#).

If Employer Z sponsors a one-participant plan required to file a Form 5500-EZ return, DFVC is not available for such plans. Form 5500-EZ filers are subject to the IRS penalties of \$25 per day, up to \$15,000. Form 5500-EZ filers should file the delinquent Form 5500-EZ return immediately, along with an explanation as to why the return wasn't filed and request a waiver of the penalty from the IRS.

[Return to Table](#)

**How to Avoid the Mistake:**

The best way to avoid this mistake is to understand your responsibilities and to file the return. Never assume someone else is filing this for you. Each plan may have a number of individuals providing service to the plan, from the CPA, to the TPA, benefits attorney, auditor, inside auditor, human resource employees, banker, financial advisor, etc. As the plan administrator, you have the responsibility for making certain you properly file the return.