401(k) Plan Fix-It Guide

Potential Mistake	Find the Mistake	Fix the Mistake	Avoid the Mistake
1) You have not updated your plan document within the past few years to reflect recent law changes. (More)	Review annual cumulative list to see if plan has all required law changes (see Notice 2011-97).	Adopt amendments for missed law changes A streamlined application is available. See Appendix F and schedules 1 and 2 of Revenue Procedure 2008-50.	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.
2) You did not base the plan's operations on the terms of the plan document. Failure to follow plan terms is a very common mistake. (More)	Independent review of plan and its operation.	Apply reasonable correction method that would place affected participants in the position they would have been if there were no operational plan defects.	Develop a communication mechanism to make all relevant parties aware of changes on a timely and accurate basis (best practices). Perform a review at least annually to ensure you are following plan terms.
3) You did not use the plan's definition of compensation correctly for all deferrals and allocations. (More)	Review the plan document.	Corrective contribution or distribution.	Perform annual reviews of compensation definitions and ensure that the person in charge of determining compensation is properly trained to understand the plan document.
4) Employer matching contributions were not made to all appropriate employees. (More)	Review the plan document to determine the correct matching contribution formula and compare it to what is used in operation.	Apply reasonable correction method that would place affected participants in the position they would have been if there were no operational plan defects.	Contact plan administrators to ensure they have adequate employment and payroll records to make calculations.
5) The plan failed the 401(k) ADP and ACP nondiscrimination tests. (More)	Independent review to determine if highly and nonhighly employees are properly classified.	Make qualified nonelective contributions for the nonhighly compensated employees.	Consider a safe harbor plan. Communicate with plan administrators to ensure proper employee classification and compliance with the plan's terms.

Potential Mistake	Find the Mistake	Fix the Mistake	Avoid the Mistake
6) Eligible employees were not given the opportunity to make an elective deferral election (exclusion of eligible employees). (More)	Review plan document sections on eligibility and participation. Check with plan administrators to find out when employees are entering the plan.	Make a qualified nonelective contribution for the employee that compensates for the missed deferral opportunity.	Monitor census information and apply participation requirements.
7) Elective deferrals were not limited to the amounts under Code section 402(g) for the calendar year and excess deferrals were not distributed. (More)	Inspect deferral amounts for plan participants to ensure the employee has not exceeded the limits.	Distribute excess deferrals.	Work with plan administrators to ensure they have sufficient payroll information to verify the deferral limitations of section 402(g) were satisfied.
8) You have not timely deposited employee elective deferrals. (More)	Determine the earliest date you can segregate deferrals from general assets; compare that date with the actual deposit dates and any plan document requirements.	Usually the Depart of Labor through their Voluntary Fiduciary Correction Program for prohibited transaction. May also be through the IRS correction program. Deposit into the plan's trust all elective deferrals withheld and earnings resulting from the late deposit.	Coordinate 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.
9) Participant loans do not conform to the requirements of the plan document and Code section 72(p). (More)	Review the plan document and all outstanding loans to ensure the loans comply with the plan's terms and that employees are repaying their loans timely.	You may correct some failures by corrective repayment and/or modification of loan terms.	Review and follow the plan provisions 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.
10) Hardship distributions were not made properly. (More)	Review all in-service distributions and determine that hardship distributions met the plan requirements.	Amend plan retroactively to allow for hardship distributions. If impermissible hardship distribution, have participant return hardship distribution amount plus earnings.	Be familiar with your plan document's hardship provisions. 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.

Potential Mistake	Find the Mistake	Fix the Mistake	Avoid the Mistake
11) The plan was top-heavy and the required minimum contributions were not made to the plan. (More)	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.	Properly contribute and allocate the required top-heavy minimum, adjusted for earnings, to the affected non-key employees.	Perform a top-heavy test each year.
12) You have not filed a Form 5500-series return and you have not distributed a Summary Annual Report to all plan participants this year. (More)	Find your signed copy of the return and determine if you filed it timely.	File all delinquent returns.	Understand your filing requirement and know who filed and when. Don't assume someone is taking care of it for you. See 401(k) Resource Guide - Plan Sponsors - Filing Requirements

401(k) Plan - Overview

Generally, Internal Revenue Code section 401(k) 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 (these employee contributions are known as elective deferrals, salary deferrals or salary reduction contributions). A 401(k) plan is also referred to as a cash or deferred arrangement, or CODA. A 401(k) plan may also include other types of employer and employee contributions.

Elective deferrals 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 Jan earns $25,000 in a year and elects to defer $3,000 into a 401(k) plan, Jan will only include $22,000 as income on that year's tax return. Although the law 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 employees to designate irrevocably some or all of their salary deferrals under the plan as designated Roth contributions. Designated Roth contributions are elective 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 employers to automatically reduce employees' wages by a fixed percentage or amount and contribute that amount to the 401(k) plan unless the employees affirmatively chose not to have their wages reduced or chose to have their 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 Internal Revenue Code section 401(a). If a plan satisfies these requirements, contributions made by the employer to the plan may be currently deductible and the contributions ordinarily will not be included in employees' gross income until distributed from the plan. If a plan fails to satisfy any of the section 401(a) requirements, the plan becomes "disqualified" and the favorable tax benefits associated with these plans may be lost.

There are several types of 401(k) plans available to employers - traditional 401(k) plans, safe harbor 401(k) plans and SIMPLE 401(k) plans. Different rules apply to each. The following is a brief description of each type of 401(k) plan:

Traditional 401(k) plans allow employees who 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 contributing for all eligible employees, matching contributions based on employees' elective deferrals, other nonelective employer contributions or any combination of these contributions. These employer contributions can be subject to a vesting schedule, which provides that after a period of time an employee's right to employer contributions becomes nonforfeitable, or they can be immediately vested. Rules relating to traditional 401(k) plans require that plan contributions meet specific nondiscrimination requirements. To ensure the plan satisfies these requirements, the employer must perform annual tests, known as the actual deferral percentage and actual contribution

percentage tests, to verify that elective deferrals and employer matching contributions do not discriminate in favor of highly compensated employees.

Plan sponsors can increase participation in 401(k) plans by adding the automatic enrollment feature in traditional 401(k) plans. An eligible automatic contribution arrangement (EACA) allows a participant to withdraw automatic enrollment elective deferrals within 90 days of the first contribution made for the participant without incurring an additional 10% tax under Code section72(t). The EACA provides a participant with a window to reconsider automatic enrollment deferrals. Any withdrawn amounts are not considered in the ADP test and any matching contributions forfeited because 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 on excess contributions under Code section 4979.

Plans with the automatic enrollment feature must take steps to ensure that amounts are withheld in a timely manner. For a discussion on finding, fixing and avoiding the failure, please see "The Fix Is In: Correcting a Failure to Implement the Plan's Automatic Enrollment Provisions."

Safe harbor 401(k) plans are similar to traditional 401(k) plans; however, if the plan meets the safe harbor requirements, the employer does not have to perform the annual ADP or ACP nondiscrimination tests that apply to traditional 401(k) plans. Plan sponsors may choose one of two safe harbor designs, each with their own set of rules. The rules for the first option are in Code section 401(k)(12). The rules for the second option are in Code section 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 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 for satisfying 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 the plan meets certain other requirements. The ADP safe harbor matching contribution requirements, however, are different for each of the safe harbor options. Both safe harbor options provide that, instead of the matching contribution, a plan can satisfy the ADP safe harbor requirement by making a nonelective contribution that is equal to at least 3% of compensation for each eligible nonhighly compensated employee.

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

(1) **Automatic enrollment feature**: A plan designed to satisfy the design option under Code section 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 requires that unless employees affirmatively elect otherwise, they are treated as they 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 day of the full plan year following the date of contribution), 4% for the plan year following the initial period, 5% for the next plan year and 6% for the years that follow. An employer may set the automatic contribution amount at a percentage that is higher than the minimums, but no 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 for the employee (or elect to have the contributions made at a different percentage). The notice should also explain how the contributions will be invested in the absence of any specific 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 section 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 Code section 401(k)(12), employees must be fully vested in ADP safe harbor contributions made for them.

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

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

Generally, the employer must provide the notice within a reasonable period - at least 30 days and not more than 90 days before the beginning of each plan year.

The failure to provide notice could cause erroneously excluded 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 traditional and safe harbor 401(k) plans are for employers of any size and employers can maintain them in addition to other retirement plans.

SIMPLE 401(k) plans are 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 only 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 use the IRS Employee Plans Compliance Resolution System to remedy your mistakes and avoid the consequences of plan disqualification. A correction for a mistake should be reasonable and appropriate. The correction method should resemble one already outlined in the Code and you should consider all applicable facts and circumstances. Rev. Proc. 2008-50, 2008-35 I.R.B. 464 is the official guidance governing the EPCRS program.

There are three ways to correct mistakes under EPCRS:

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

Below is a general description of each component of EPCRS:

Self-Correction Program:

- To be eligible for SCP, the sponsor or administrator of a plan must have established practices and procedures (formal or informal) reasonably designed to promote and facilitate overall compliance with the law. A plan document alone does not constitute evidence of established procedures.
- SCP is available for correcting operational problems only – that is, the failure to follow the plan terms. SCP is not available for problems with the plan document, such as the failure to keep your plan document current to reflect changes in the law.
- The plan sponsor effects correction using the General Correction Principles in Rev. Proc. 2008-50.
- A plan sponsor that corrects a failure listed in Appendix A or Appendix B of Rev. Proc. 2008-50 according to the correction methods listed may be certain that their correction is reasonable and appropriate for the failure.
- If needed, the plan sponsor should make changes to its administrative procedures to ensure 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.

Voluntary Correction Program:

- The plan sponsor:
    1) identifies the failures.
    2) proposes correction using the General Correction Principles in Rev. Proc. 2008-50, section 6.
    3) proposes changes to its administrative procedures to ensure the mistakes do not recur.

4) pays a compliance fee that generally is based on the number of plan participants 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 detailing the mistakes identified by the employer and correction methods approved by the IRS.
- The plan sponsor corrects the identified mistakes within 150 days of the issuance of the Compliance Statement.
- While the IRS is processing the submission, IRS will not examine the plan, except under unusual circumstances.

Audit Closing Agreement Program:

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

Return to Table

Potential Mistake	Find the Mistake	Fix the Mistake	Avoid the Mistake
1) You have not updated your plan document within the past few years to reflect recent law changes. (More)	Review annual cumulative list to see if plan made all required law changes (Notice 2011-97)	Streamlined application available. See Appendix F and schedules 1 and 2 Adopt amendments for missed law changes	Use 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

1) You have not updated your plan document within the past few years to reflect recent law changes.

A basic legal requirement of all 401(k) plans is that they must be established and supported by a formal written plan document that complies with the Internal Revenue Code. When the tax laws affecting 401(k) plans change, the written plan must be updated. The IRS generally establishes a firm deadline by which plan amendments that reflect tax law changes must be adopted. This applies to all 401(k) plans, whether active or not, as long as assets remain in the retirement plan. Note: Federal tax laws related to 401(k) plans change often. Plans not timely amended are no longer considered qualified retirement plans subject to favorable tax treatment under the federal tax code.

How to Find the Mistake:

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

- you have timely adopted:
  - a written plan document, and
  - any necessary amendments to reflect tax law changes; and
- the plan document is in compliance with the form requirements of the Code.

You should keep the following documents to prove you have timely amended your plan:

- Original plan document
- All subsequent plan amendments or restatements
- All adoption agreements (a document provided by an Master & Prototype sponsor or Volume Submitter practitioner that allows you to choose plan design options, 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 IRS opinion or advisory letter
- Any IRS determination letter
- Board of Director's resolutions and minutes, or similar records related to the plan.

If some of the above adoption agreements, amendments or plan restatements are missing or if you have not updated the plan document in some time this may indicate that you have not timely updated the written 401(k) plan to comply with changes in the tax law. The chart shown below gives you some idea of the amendments you must have adopted in the last few years.

Types of plan documents

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 the IRS has already reviewed favorably.

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 IRS opinion or advisory letter approving the form of the plan document. You may adopt a pre-approved plan from an M&P sponsor or VS practitioner. An individually designed plan document is tailored to meet the particular needs of an employer by providing the maximum amount of flexibility in plan design. The IRS has not pre-reviewed it.

Updating plan documents

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

For tax laws and IRS guidance enacted:

- prior to 2001:
  - 401(k) plans needed to be amended and restated by an IRS specified date.
- after 2000:
  - The IRS required plan sponsors to adopt stand-alone good-faith amendments and/or interim amendments to have access to the extended deadline that allowed plans to be amended and restated for tax law changes.

In 2005, the IRS issued a Revenue Procedure which required 401(k) plans to be amended and restated every five years for individually designed plans (or six years if a pre-approved plan document is used)**.** This guidance also established deadlines for interim and discretionary plan amendments. Finally, the Procedure provided guidance on when taxpayers may submit determination letter applications to the IRS using a revolving cycle system. Under that system, individually designed plans are assigned a specific five-year cycle (Cycles A-E), which is generally based on the last digit of the plan sponsor's employer identification number. The 2005 Revenue Procedure was updated and currently Revenue Procedure 2007-44 describes this system. If you use a pre-approved plan document, the institution who maintains the plan document will contact you when you need to update the plan.

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

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

- a **discretionary amendment** by the:
    - end of the plan year in which the plan amendment is effective.

An interim amendment does not include any amendment adopted to:

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

Example:
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.

Example:
An amendment adopted to bring a plan into compliance with GUST or any other previous legislation is not a good faith or interim amendment.

Cumulative List

The IRS publishes a Cumulative List of Changes in Plan Qualification Requirements toward the end of each year. It will help you to determine what interim amendments need to be adopted and will help you understand what amendments have to be finalized in your plan by the end of your current 5-year cycle. The most current Cumulative List, in Notice 2011-97, is for Cycle B plan sponsors to use in drafting their plans for the submission period ending on January 31, 2013.

The following items summarize some of the major tax laws or IRS guidance that apply to 401(k) plans and were enacted after 2001, where the plan amendment deadline has expired. This is not a complete or comprehensive list. For a more detailed list of changes, refer to the applicable Cumulative List.

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

Tax Law/IRS Guidance	Major Provisions	Amendment Deadlines
Worker, Retiree, and Employer Recovery Act of 2008 (WRERA)	• Allowed required minimum distributions (RMD) associated with the 2009 calendar year to be suspended or reduced. • Distributions made on or after January 1, 2010, must allow for non-spouse beneficiary distributions via direct rollover. • Retroactive technical corrections to the PPA.	• RMD provision – The amendment deadline is generally the last day of the first plan year that began on or after January 1, 2011 If your plan did not suspend or reduce RMDs during 2009 then no plan amendment was necessary (See Notice 2009-82). • Distribution requirement – The amendment deadline is generally the filing deadline for the plan sponsor's 2010 tax return. • However, the deadline was January 31, 2011 for plan sponsors: o who use an individually designed plan, and o whose EIN ends in 5 or 0. Amendment deadline for PPA technical corrections is by the end of the 2009 plan year. For calendar year plans, the deadline was December 31, 2009.
Heroes Earnings Assistance and Relief Tax Act Of 2008 (HEART)	Requires all 401(k) plans to be amended for special benefits for plan participants who are or who may perform qualified military service.	The last day of the first plan year that began on or after January 1, 2010. For calendar year plans, the deadline was December 31, 2010.

Tax Law/IRS Guidance	Major Provisions	Amendment Deadlines
Pension Protection Act of 2006 (PPA)	Requires faster vesting of employer contributions, simplifies 401(k) administration, diversification of plan investments, increased portability for distributions, etc. Also permits additional new automatic contribution arrangements and other optional benefits. Temporary provisions of a 2001 tax law change were made permanent.	The last day of the first plan year that began on or after January 1, 2009. For calendar year plans, the deadline was December 31, 2009. Specific PPA amendments relating to the diversification of investments did not have to be adopted until the end of the first plan year that begins on or after January 1, 2010 (See Notice 2009-97) For calendar year plans the deadline for this specific item was December 31, 2010.
Final Code section 415 regulations	Numerous changes to plan language associated with Code section 415(c) effective for limitation years beginning on or after July 1, 2007.	The later of: • the last day of the plan year in which the amendment was effective, or • the extended due date of the employer's tax return for the year which includes the effective date. For many plans, the amendment deadline is the filing deadline for the plan sponsor's 2008 tax return. The deadline may be earlier if your plan has a non-calendar plan year, limitation year or both. The deadline was January 31, 2009 for plan sponsors: • who use an individually designed plan, and • whose EIN ends in 3 or 8.

Tax Law/IRS Guidance	Major Provisions	Amendment Deadlines
Final Code sections 401(k) and 401(m) regulations	Made changes to 401(k) administration and was mandatorily effective for plan years beginning on or after January 1, 2006.	For many plans, the filing deadline for the plan sponsor's 2006 tax return. However, some plan sponsors who use an individually designed plan and fall under Cycle A or B had an earlier deadline. If the regulations were optionally applied in 2005, the amendment needed to be adopted by December 31, 2005.
Automatic rollover provision associated with Code section 401(a)(31)(B) and Notice 2005-5.	Changes to the rules related to mandatory distributions of benefits. Applicable to all plans on or after March 25, 2005.	The later of: • December 31, 2005, or • the filing deadline of the 2005 tax return for the plan sponsor.
Final Code section 401(a)(9) regulations	Various changes to the rules regarding required minimum distributions. Applies to all plans starting in 2003.	Good faith amendment generally needed to be adopted by the last day of the first plan year that began on or after January 1, 2003. If good faith amendments were timely adopted, a restated plan document that fixed any defects or minor omissions needed to be adopted by the end of the plan sponsor's applicable cycle that included EGTRRA as set forth in Revenue Procedure 2007-44. Plan sponsors who use pre-approved plans the end of the applicable remedial amendment period was April 30, 2010. See Announcement 2008-23.

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

Prior to 2001, there were other tax laws that applied to 401(k) plans. The statutory changes preceding EGTRRA are referred to as GUST, 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 due date, then you are a late/nonamender, and your plan does not comply with the law and is no longer qualified.

How to Fix the Mistake:

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

- Adopt amendments for the tax law changes you 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. For individually designed plans, the IRS has published some suggested sample language as part of a package of Listing of Required Modifications (LRMs).
- Model amendments issued by the IRS may be useful for plan sponsors in the effort to amend the plan to conform to tax law changes. The following items of guidance released by the IRS contain model or sample plan amendments:
  - 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 section 414(w) (permitting 90-day withdrawals) to a 401(k) plan.
- Also, you may have to adopt a pre-approved plan from an M&P sponsor or VS practitioner.
- Generally, the effective date of the amendment should be retroactive to conform the plan's terms to the requirements of the legislation.
- File a VCP submission with the IRS using Revenue Procedure 2008-50.

If the only mistake in the VCP submission involves the late adoption of interim amendments or amendments required to implement an optional law change, then the plan sponsor can use Appendix F, Schedule 1 of Revenue Procedure 2008-50, a simplified filing procedure. The resolution of certain interim or optional law change amendment failures, using Schedule 1 results in the IRS treating the corrective amendment as if the plan sponsor had adopted it timely 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 or optional law change 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. In that case, check the box indicating that the plan was not timely amended for the Cumulative List that included the late good faith/interim amendment. For details on how nonamender failures should be resolved under VCP, please see "Nonamender Failures and the Voluntary Correction Program (VCP)."

Correction Program(s) Available:

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

Voluntary Correction Program:

If the plan is not under examination, your may make a VCP submission to the IRS.
There is a fee for this mistake. See Section 12 of Rev. Proc. 2008-50.

Example 1:
The XYZ Company adopted and maintains a pre-approved 401(k) plan using the calendar year as its plan year. The 2010 form 5500 indicated that the plan had 40 participants. In 2011, the plan's administrator determined that the XYZ Company did not adopt interim amendments

associated with PPA by December 31, 2009 as required by their pre-approved plan's provider. Since the special remedial amendment period for pre-approved plans that includes the PPA changes is still considered open in 2011 when the VCP submission is filed with the Service, this problem is considered a late interim amendment failure. The fee for this size plan would normally be $1,000; however, if the failure to adopt timely interim amendments is the only mistake in the submission, there is a reduced fee of $375 regardless of the number of participants in the plan (see section 12.03 of Rev. Proc. 2008-50). XYZ Company may use the streamlined application procedure for good faith nonamenders in Appendix F and Appendix F-Schedule 1 of Revenue Procedure 2008-50. Note: You must list all specific late PPA amendments on Schedule 1.

Example 2:
Same facts as Example 1, except XYZ Company did not timely amend its plan for changes in the law mandated by EGTRRA. XYZ Company should have adopted EGTRRA good faith amendments by September 30, 2003. In addition, most pre-approved document providers required their clients to adopt an EGTRRA pre-approved restated plan document by April 30, 2010 in order to be considered timely amended. XYZ Company may use the streamlined application procedure for non-amenders in Appendix F and Appendix F-Schedule 2 of Revenue Procedure 2008-50. The VCP compliance fee is $1,000. If you use a pre-approved plan and did not timely amend for EGTRRA, consult the VCP Submission Kit.

Example 3:
ABC Corporation sponsors a 401(k) and uses an individually designed plan document. ABC's EIN ends in zero and, therefore, falls under Cycle E, which is associated with the 2009 Cumulative List. The remedial amendment period for this cycle ended on January 31, 2011, assuming ABC adopted all good faith/interim amendments timely. The 2010 form 5500 indicated that the plan had 450 participants. After January 31, 2011, ABC's plan consultants determined that ABC Corporation did not adopt interim amendments associated with the final 415 regulations and PPA by January 31, 2011. In addition, such provisions were not adopted in any form by January 31, 2011. The consultants also found that there was additional defective plan language. Because the remedial amendment cycle that includes PPA and the final 415 regulations closed before ABC could adopt the amendments, this failure is not eligible for the reduced $375 fee associated with submissions that include only interim amendment failures. ABC cannot use Appendix F Schedule 1. In addition, the other defective plan language problems cannot be corrected under Schedule 1 because the remedial amendment period closed on January 31, 2011. Instead, ABC must use Schedule 2 and check the box that indicates that the plan was not timely amended for the 2009 Cumulative List.

The fee in this case is generally $5,000; however, if the only mistake was being a late amender for Cycle E (due date/end of remedial amendment cycle was January 31, 2011) and ABC files a VCP submission within one year of the end of Cycle E (by January 31, 2012), then the VCP fee would be reduced by 50% of the normal fee provided for in the fee chart. In that case the fee would be $2,500 ($5,000 x 50% = $2,500). See section 12.03 of Revenue Procedure 2008-50).

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

If an IRS agent discovers this mistake during the determination letter process, it 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 to avoid the higher fee.

How to Avoid the Mistake:

There are a number of ways to avoid this mistake:

- Use 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 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, bank or law firm 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.

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Potential Mistake	Find the Mistake	Fix the Mistake	Avoid the Mistake
2) You did not base the plan's operations on the terms of the plan document. Failure to follow plan terms is a very common mistake (More)	Independent review of plan and its operation	Apply reasonable correction method that would place affected participants in the position they would have been if there were no operational plan defects	Develop a communication mechanism to make all relevant parties aware of changes on a timely and accurate basis (best practices). Perform a review at least annually to ensure you are following plan terms

2) You did not base the plan's operations on the terms of the plan document.

The plan sponsor/employer is responsible for keeping the plan in compliance with the tax laws; however, there may be many employees, vendors and tax professionals servicing your plan. The fiduciary responsibility rules in Employee Retirement Income Security Act under the Department of Labor's jurisdiction require that fiduciaries follow the plan's terms insofar as they are consistent with ERISA.

You should convey any changes made to your plan document or to your plan's operation to everyone providing service to your plan. For example, if 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. Also, if you decide to use a different definition of compensation in operation, make sure you amend the plan timely to reflect that change. Below are some common changes requiring due diligence to identify any potential mistakes.

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

How to Find the Mistake:

You must be familiar with your plan document to be able to determine if you have operated it according to its terms. Following the plan document's terms is crucial to ensure tax-favored

treatment of the plan and to prevent a breach of fiduciary duty under ERISA. Be familiar with the plan document's wording and how it affects the plan's operation. Conduct an independent review of your plan and its operation annually. If you operate your plan using a summary, check the requirements and definitions on that sheet to make certain they correspond to the plan document. Consider conducting a 401(k) plan check-up using the 401(k) plan checklist.

How to Fix the Mistake:

Corrective Action:
If you find an error in the operation of your plan, correct the error as soon as possible. Use a reasonable correction method that places affected participants in the position they would have been had mistake not occurred. Section 6 of Rev. Proc. 2008-50 provides general correction principles you should use in determining an appropriate correction method. A plan sponsor that corrects a mistake listed in Appendix A or Appendix B of Rev. Proc. 2008-50 according to the correction methods listed may be certain that their correction is reasonable and appropriate for the failure.

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, 2007, to September 30, 2010, when he terminated employment. Bob worked 2,000 hours in 2007, 2008 and 2009, and during 2010, 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 Employer A should have credited Bob with a vesting year of service for 2010 since he worked in excess of 1,000 hours in that plan year. Bob should have been 80% vested for the 4 years of vesting service.

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

Correction Program(s) Available:

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

- No fees for self-correction.
- Practices and procedures must be in place.
- If the mistakes are **significant** in the aggregate:
    - Employer A needs to make corrective distribution by December 31, 2012.
    - If not corrected by December 31, 2012, Employer A is not eligible for SCP and must correct under VCP.

- If the mistakes are **insignificant** in the aggregate, Employer A can make a corrective distribution beyond the two-year correction period for significant errors. Whether a mistake is insignificant is dependent on all the facts and circumstances.

Voluntary Correction Program:
Under VCP, correction is the same as described above under SCP. Employer A makes a VCP submission according to 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 Closing Agreement Program:
Under Audit CAP, correction is the same as described above under SCP. Employer A and the IRS enter into a closing agreement outlining the corrective action and negotiate a sanction based on the Maximum Payment Amount.

How to Avoid the Mistake:
Be sure to apply the provisions of the plan correctly when making a determination of what contributions or benefits 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

Potential Mistake	Find the Mistake	Fix the Mistake	Avoid the Mistake
3) You did not use the plan's definition of compensation correctly for all deferrals and allocations. (More)	Review the plan document.	Corrective contribution or distribution.	Perform annual reviews of compensation definitions and ensure that the person in charge of determining compensation is properly trained to understand the plan document.

3) You did not use the plan's definition of compensation correctly for all deferrals and allocations.

Because your plan may use different definitions of compensation for different purposes, it's important to apply the proper definition when dealing with deferrals and allocations. A plan's compensation definition must satisfy rules for determining the amount of contributions. The amount of compensation taken into account under the plan cannot exceed $250,000 in 2012, and is subject to cost-of-living adjustments for later years. This limit is described in Code section 401(a)(17).

You must follow the plan document's compensation definition 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

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

How to Find the Mistake:

Review the plan document to determine if you are using the proper compensation for allocations and deferrals. Many plan sponsors operate their plans based on a plan summary 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 adoption agreement, which discusses how the plan must make allocations and 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.

How to Fix the Mistake:

Corrective Action:
There are a couple of ways to make corrections when you have improperly allocated amounts based on compensation. If you have improperly determined elective deferrals, make a distribution of the excess amount plus earnings to the participant. If there are improper profit-sharing allocations, 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, make a corrective contribution, including earnings, for the affected participants.

Example:
Employer Z sponsors a 401(k) plan, with 6 participants. The plan’s definition of compensation for deferrals and allocations was amended, effective 2005, to exclude bonuses. For the 2010-plan year, Employer Z did not exclude bonuses from compensation before determining allocations and deferrals. Three highly compensated employees 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 the 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.

Correction Program(s) Available:

Self-Correction Program:
The example illustrates an operational problem, because Employer Z did not follow the plan’s terms by including bonuses in compensation used to determine plan allocations. Therefore, if the other eligibility requirements are satisfied, Employer Z may use SCP to correct the mistake.

- No fees for self-correction.
- Practices and procedures must be in place.
- If the mistakes are **significant** in the aggregate:
    - Employer Z needs to complete correction by December 31, 2012.
    - If not corrected by December 31, 2012, Employer Z is not eligible for SCP and must correct under VCP.

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

Voluntary Correction Program:
Under VCP, correction is the same as described under SCP. Employer Z makes a VCP submission according to 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 Closing Agreement Program:
Under Audit CAP, correction is the same as described under SCP. Employer Z and the IRS enter into a closing agreement outlining the corrective action and negotiate a sanction based on the Maximum Payment Amount.

How to Avoid the Mistake:

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.
- 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.

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Potential Mistake	Find the Mistake	Fix the Mistake	Avoid the Mistake
4) Employer matching contributions were not made to all appropriate employees. (More)	Review the plan document to determine the correct matching contribution formula and compare it to what is used in operation.	Apply reasonable correction method that would place affected participants in the position they would have been if there were no operational plan defects.	Contact plan administrators to ensure they have adequate employment and payroll records to make calculations.

4) Employer matching contributions were not made to all appropriate employees.

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 when calculating the matching contribution as required under the plan document.

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

How to Find the Mistake:

To avoid mistakes in this area:

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

How to Fix the Mistake:

Corrective Action:
You should base correction of an incorrect employer matching contribution on the plan's terms and other applicable information at the time of the mistake (see section 6.02 of Rev. Proc. 2008-50).

Example:
Employer D sponsors a 401(k) plan with a calendar-year plan year and 20 participants. The plan document provides that D 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 2010-plan year, D erroneously computed its match based on 50% of the amount deferred by Carla for the year up to 3% of compensation instead of 6% of compensation. Carla received $50,000 in compensation and elected an 8% rate of deferral ($50,000 x 8% = $4,000 elective deferrals). Employer D provided a matching contribution to Carla totaling $750 ($50,000 x 3% x 50%). Under the plan's terms, Carla was entitled to a $1,500 match ($50,000 x 6% x 50%). As a result, Employer D needs to make a corrective contribution of $750 plus earnings for Carla to correct the operational mistake.

Correction Program(s) Available:

Self-Correction Program:
The example illustrates an operational problem because the employer didn't follow the plan's terms and improperly applied the plan's matching contribution formula. 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, 2012.
  - If not corrected by December 31, 2012, Employer D is not eligible for SCP and must correct under VCP.
- If the mistakes are **insignificant** in the aggregate, Employer D can correct beyond the two-year correction period for significant errors. Whether a mistake is insignificant depends on all the facts and circumstances.

Voluntary Correction Program:
Under VCP, correction is the same as described under SCP. Employer D makes a VCP submission according to 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 Closing Agreement Program:
Under Audit CAP, correction is the same as described under SCP. Employer D and the IRS enter into a closing agreement outlining the corrective action and negotiate a sanction based on the Maximum Payment Amount.

How to Avoid the Mistake:

Be familiar with your plan document's terms and implement procedures to ensure that your plan operates according to your plan document. 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 plan document's terms.

Return to Table

Potential Mistake	Find the Mistake	Fix the Mistake	Avoid the Mistake
5) The plan failed the 401(k) ADP and ACP nondiscrimination tests. (More)	Independent review to determine if HCEs and NHCEs are properly classified.	Make qualified nonelective contributions for the NHCEs	Consider a safe harbor plan. Communicate with plan administrators to ensure proper employee classification and compliance with the plan's terms

5) The plan failed the 401(k) ADP and ACP nondiscrimination 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), are proportional to contributions made for owners and managers, (highly compensated employees). As the NHCEs save more for retirement, the rules allow HCEs to defer more. These nondiscrimination tests for 401(k) plans are known as the Actual Deferral Percentage and Actual Contribution Percentage tests.

The ADP test applies to elective deferrals (including both before-tax deferrals and Roth deferrals) of the HCEs and NHCEs. Dividing a participant's elective deferrals by the participant's compensation will give you that participant's Actual Deferral Ratio. 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 or prior year contributions. 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 properly identify the HCEs. Code section 414(q) defines HCEs to generally include 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 $115,000 (for 2012 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.

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.

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.
    - Plan administrators need access to ownership documents to identify 5% owners.
    - Take care to identify family members of the owners, as many will have different last names, 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.

How to Fix the Mistake:

Corrective Action:
If your plan fails the ADP and/or ACP tests 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 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 – The permitted correction method under Rev. Proc. 2008-50, Appendix A, section .03, 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 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 (if the contribution does not cause the Code section 415 limit to be exceeded). The 415 limit is 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 - An alternative permitted correction method (referred to as the one-to-one method) under Rev. Proc. 2008-50, Appendix B, section 2.0:
    - Excess contributions (adjusted for earnings) are assigned and distributed to the HCEs.
    - Any amounts forfeited because of matching contributions are to be used according to the plan document provisions relating to forfeiture.
    - That same dollar amount (in other words, the excess contribution, 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 2012, G performed a review of the plan's operations for the 2010 plan year. During this review, G discovered one participant identified as a 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 2010 plan year. The plan has 21 participants.

Correction Program(s) Available:

Self-Correction Program:
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 (if 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 2010, with the regulatory correction period ending in 2012, so the correction period under SCP for significant mistakes ends on the last day of the 2013 plan year.

Voluntary Correction Program:
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 Closing Agreement Program:
Most plans are eligible for Audit CAP, which allows the plan sponsor to correct the mistake and pay a negotiated sanction. This sanction will bear a reasonable relationship to the nature, extent, and severity of the mistake, 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.

How to Avoid the Mistake:

One way to avoid this type of mistake is by establishing a safe harbor 401(k) plan or by changing an existing plan from a traditional 401(k) plan to a safe harbor 401(k) plan. Under a safe harbor 401(k) plan, the employer 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 plan administrator on all employees eligible to make an elective deferral (including all eligible employees who terminated either voluntarily or involuntarily during the year).
- Share information regarding any related companies with common ownership interests with the plan administrator.
  - 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 your plan document to ensure that you use the proper definition of compensation.
  - It's important to know whether compensation is:
    - Excluded for certain purposes,
    - Limited for certain purposes, or
    - Determined using a different computation period (for example, plan year vs. calendar year).
  - If the compensation amounts forwarded to the plan administrator 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 plan administrator with all of the information needed to make a proper determination of each employee's status.

If either the ADP or the ACP test fails, then, to avoid having to correct under EPCRS, implement procedures to ensure that you correct excess contributions and/or excess aggregate contributions in a timely manner. Excess contributions result from plans failing to satisfy the ADP test and should be distributed to the applicable HCEs within 12 months following the close of the plan year. Excess aggregate contributions are contributions resulting from a plan that has failed the ACP test. The law generally treats them 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 these in an unallocated suspense account to use to reduce future contributions.

Return to Table

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

6) Eligible employees were not given the opportunity to make an elective deferral election (excluding eligible employees).

Your plan document should contain a specific definition of "employee" and provide requirements for when employees must 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 the accuracy of employee data such as dates of birth, hire, and termination; number of hours worked; compensation for the plan year; 401(k) election information and any other information necessary to properly administer the plan.

Generally, treat each employee who receives a Form W-2 as an eligible employee unless you can properly exclude that employee by the plan's terms. Using the plan's definition of eligible employee along with the plan's age and service requirements, determine each employee's eligibility. 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 for it to maintain tax-favored treatment. These general rules are:

- A plan may not require an employee to be older than 21 to participate in a plan, and
- There are two ways to credit service to an employee:
    - hours of service measured in the context of a year of service (the more common method) or
    - 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 generally determined in 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.

How to Find the Mistake:

Review your plan document 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.

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 to the plan for the employee. This contribution must compensate 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 timely.

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

Example:
Employer D sponsors a 401(k) plan with eight participants. The plan uses 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, to whom Employer D should have provided the opportunity to make elective deferrals on January 1, 2010, was not provided the opportunity until January 1, 2011. Jack was a NHCE with compensation for 2010 of $80,000. The ADP for HCEs for 2010 was 10%. The ADP for NHCEs for 2010 was 8%. Employer D discovers this mistake during a review of the plan in 2011.

Employer D must make a corrective contribution for the 2010 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, 2010). 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.

Correction Program(s) Available:

Self-Correction Program:
The example illustrates an operational problem because the employer failed to follow the plan's terms by not giving Jack the opportunity to participant in the plan for the 2010-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, 2012.
  - If not corrected by December 31, 2012, Employer D is not eligible for SCP and must correct under VCP.
- If the mistakes are **insignificant** in the aggregate, Employer D can correct beyond the two-year correction period for significant errors. Whether or not a mistake is insignificant is dependent on all the facts and circumstances.

Voluntary Correction Program:
Under VCP, correction is the same as described under SCP. Employer D makes a VCP submission according to 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 Closing Agreement Program:
Under Audit CAP, correction is the same as described under SCP. Employer D and the IRS enter into a closing agreement outlining the corrective action and negotiate a sanction based on the Maximum Payment Amount.

How to Avoid the Mistake:

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 and compare the employees on these records with the payroll records to see if employee counts are accurate.

Return to Table

Potential Mistake	Find the Mistake	Fix the Mistake	Avoid the Mistake
7) Elective deferrals were not limited to the amounts under Code section 402(g) for the calendar year and excess deferrals were not distributed. (More)	Inspect deferral amounts for plan participants to ensure the employee has not exceeded the limits.	Distribute excess deferrals.	Work with plan administrators to ensure they have sufficient payroll information to verify the deferral limitations of §402(g) were satisfied.

7) Elective deferrals were not limited to the amounts under Code section 402(g) for the calendar year and excess deferrals were not distributed.

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

- 2011 - $16,500
- 2012 - $17,000
- This limit is subject to cost-of-living increases after 2012. (For 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 $11,500 for 2011 and 2012.
- This limit is subject to cost-of-living increases after 2012.

Catch-up contributions: A plan may permit participants, age 50 or over at the end of the calendar year, to make additional elective deferrals. These additional contributions are commonly referred to as catch-up contributions, and 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 2011 and 2012.
    - The limit is subject to cost-of-living increases after 2012.

- 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 2011 and 2012.
    - The limit is subject to cost-of-living increases after 2012.

- The catch-up contribution for a year cannot exceed the lesser of the following amounts:
    - The catch-up contribution limit, 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 section 401(a)(30) plan qualification rule referred to above. The maximum limits for catch-up contributions are found in Code section 414(v).

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 section 402(g) limits. If an employee has elective deferrals in excess of the section 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 to meet certain nondiscrimination requirements.

If the total of a plan participant's elective deferrals is more than the limit under Code section 402(g), to avoid failing Code section 401(a)(30), the excess amount plus allocable earnings must be distributed to the participant by April 15 of the year following the year in which the excess occurred. Excess deferrals not timely returned to the participant are subject to additional tax. 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 section 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 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 the amounts were deferred. Excess deferrals distributed to NHCEs are not included in the ADP test if 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.

How to Find the Mistake:

Ensure that no participants' elective deferrals exceed the section 402(g) limit for a year by comparing the amount of each participant's elective deferrals to the section 402(g) limit. If the section 402(g) limit is surpassed by any participant during the year and not corrected, there could be a violation of Code section 401(a)(30), causing your plan to become disqualified.

How to Fix the Mistake:

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

- Under Rev. Proc. 2008-50, Appendix A, section .04, the permitted correction method is to distribute the excess deferral to the employee and to report the amount as taxable **both** in the year of deferral and in the year distributed as provided by the Code and regulations under section 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 401(k) plan, which has 21 participants. For calendar year 2010, Ann defers $17,500 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 $16,500 is the §402(g) maximum amounted permitted for 2010. Employer X does not discover this mistake until after April 15, 2011. On November 1, 2011, X distributes the excess deferral (plus applicable earnings of $100, totaling $1,100) to Ann.

For 2010 (year of deferral), Ann must include **$1,000** in gross income. For 2011 (year of distribution), Ann must include **$1,100** in gross income. Employer X would show this amount on a Form 1099-R. In addition, Ann must pay the Code section 72(t) tax.

Correction Program(s) Available:

Self-Correction Program:
The example illustrates an operational problem, because the employer failed to follow the plan terms prohibiting any employee's elective deferrals from exceeding the section 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, 2012.
  - If not corrected by December 31, 2012, Employer X is not eligible for SCP and must correct under VCP.
- If the mistakes are **insignificant** in the aggregate**,** Employer X can correct beyond the two-year correction period for significant errors. Whether or not a mistake is insignificant depends on all the facts and circumstances.

Voluntary Correction Program:
Under VCP, correction is the same as described under SCP. Employer X makes a VCP submission according to 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 Closing Agreement Program:
Under Audit CAP, correction is the same as described under SCP. Employer X and the IRS enter into a closing agreement outlining the corrective action and negotiate a sanction based on the Maximum Payment Amount.

How to Avoid the Mistake:

Work with your plan administrator to ensure that the administrator has sufficient payroll information to verify the deferral limitations of section 402(g) were satisfied. Have procedures in place to ensure that, based on the participant election forms (including modifications), participants will not exceed the section 402(g) limit. In addition, have checks and balances in place to alert you and your plan administrator when a participant exceeds the limit so you can take timely corrective action.

Return to Table

Potential Mistake	Find the Mistake	Fix the Mistake	Avoid the Mistake
8) You have not timely deposited employee elective deferrals. (More)	Determine the earliest date you can segregate deferrals from general assets; compare that date with the actual deposit dates and any plan document requirements.	Usually Department of Labor through VFCP for prohibited transaction. May also be EPCRS. Deposit into the plan's trust all elective deferrals withheld and earnings resulting from the late deposit	Coordinate 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.

8) You have not timely deposited employee elective deferrals.

The employer is responsible for contributing the amounts of elective deferrals made by plan participants to the trust. If your plan document contains language regarding the timing of deposits of elective deferrals, you may correct failures to follow the plan document's terms 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 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 involving 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 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 15th business day of the following month. Keep in mind that the rules regarding the 15th business day of the following month do not provide a safe harbor for depositing deferrals; rather, these rules set the maximum deadline for deposit. DOL provides 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.

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

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 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.
- 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.

How to Find the Mistake:

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, 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 according to the plan document, which can be corrected under EPCRS.

How to Fix the Mistake:

Corrective Action:
Correction through EPCRS may be required if the terms of the plan 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, along with lost earnings, into the trust..
- Review procedures and correct deficiencies that led to the late deposits.

Example:
Employer B sponsors a 401(k) plan for its 1,200 employees, all of whom are 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 2010 plan year.

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.

Self-Correction Program:
The example illustrates an operational problem because the employer did not 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, 2012.
    - If not corrected by December 31, 2012, Employer B is not eligible for SCP and must correct under VCP.
- If the mistakes are **insignificant** in the aggregate, Employer B can correct beyond the two-year correction period for significant errors. Whether or not a mistake is insignificant depends on all the facts and circumstances.

Voluntary Correction Program:
Under VCP, correction is the same as described under SCP. Employer B makes a VCP submission according to 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 Closing Agreement Program:
Under Audit CAP, correction is the same as described 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.

How to Avoid the Mistake:

Establish a procedure where you deposit elective deferrals coincident with or after each payroll according to the plan document. If you have instances where your deferral deposits are a week or two later than the normal timely deposit (because of 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

Potential Mistake	Find the Mistake	Fix the Mistake	Avoid the Mistake
9) Participant loans do not conform to the requirements of the plan document and Code section 72(p). (More)	Review the plan document and all outstanding loans to ensure that the loans comply with the plan's terms and employees are repaying their loans timely.	You may correct some failures by corrective repayment and/or modification of loan terms.	Review and follow the plan provisions 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.

9) a) Participant loans do not conform to the requirements of the plan document and Code section 72(p).

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

A loan to a participant must meet a number of rules under Code section 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 stating the date and amount of the loan and binding the participant to a repayment schedule that would ensure that he or she repays the loan.
    b. The participant must adequately secure the loan and the loan's terms, 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 the participant's 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 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 or 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 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.

How to Find the Mistake:

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

- Determining whether there are written loan agreements for outstanding loans. If not, the loan is a taxable distribution to the participant.
- Reviewing each loan agreement's terms to ensure that they meet the rules required to exempt the loan 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 showing 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 loan amount less than the dollar limit? To address this question, you would need to know the participant's vested account balance as of the loan date, 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 according to 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. Pay particular attention to this issue if there has been a change in payroll systems or providers.

How to Fix the Mistake:

Corrective Action:
It is important that plans have a system in place to ensure that a participant loan's terms and its 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 in which 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 plan document's terms and/or Code section 72(p), the plan sponsor has two choices. It may be able to use the Voluntary Correction Program to permit employees to include the amount of the loan in income 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, 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 repayment date over the original loan's remaining period. The corrective payment for the excess loan amount depends on the:
        - excess amount as of the date of the loan,
        - payments previously made on the loan, and
        - portion of the previously made payments that were allocated to the excess loan amount.

      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:
        (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.
        (2) Prior repayments are used to pay the interest on the excess portion of the loan, with the remainder of the repayments used to reduce the portion of the loan that did not exceed the limit. The corrective payment for the excess loan amount is equal to the original excess loan amount.
        (3) Prior repayments are applied against the loan excess and the maximum loan amount permitted on a pro-rata basis. The corrective payment for the excess loan amount is equal to the outstanding loan balance attributable to the excess loan amount, after the allocation of prior repayments.
    - **Loan that exceeds the maximum loan period:** The outstanding amount of the loan is reamortized over the maximum remaining period allowed under Code section 72(p) (5 years) from the original loan date.
    - **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 whom 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, 2010. The loan was for $60,000 over a five-year term, amortized monthly using a reasonable interest rate. Bob timely made the required payments. The loan amount is less than 50% of Bob's vested account balance. However, the loan amount exceeds the maximum limit of $50,000.
- Terri received a loan of $10,000, dated April 1, 2010, 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.
- Dean borrowed $10,000, dated March 1, 2010, over a five-year period. Because of a payroll error, AZCorp failed to withhold the required loan repayments from Dean's pay since August 1, 2010. 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, 2011.

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 because of the $10,000 loan excess, according to Method 3, above. Since Bob has already repaid some of the loan, these repaid amounts may be taken into account in determining the amount of the required corrective repayment. AZCorp applied Bob's prior repayments on a pro-rata basis between the $10,000 loan excess and the $50,000 maximum loan amount. Therefore, Bob's corrective repayment equaled the balance remaining on the $10,000 loan excess as of February 1, 2011, the date of correction.

Terri – Loan term in excess of the 5-year limit - AZCorp is correcting this mistake by reamortizing the loan balance over the maximum remaining period (5 years) from the original loan date. On February 1, 2011, AZCorp reamortized the balance of the loan for Terri so that it will be fully repaid by April 1, 2015 (5 years from the date of the original loan).

Dean – Loan payments not made - The loan went into default as of November 2, 2010, upon the expiration of the plan's stated three-month cure period. It was determined the employer was partially at fault because it failed to collect loan repayments. AZCorp corrected the mistake by requiring Dean to make a lump sum repayment equal to the additional interest accrued on the loan and reamortize the outstanding balance over the remaining loan period.

Correction Program(s) Available:

Self-Correction Program:
This type of mistake may not be corrected under SCP. To obtain relief, this mistake must be corrected under VCP.

Voluntary Correction Program:
AZCorp makes a VCP submission according to 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% when 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 Closing Agreement Program:
Under Audit CAP, correction is the same as described 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.

How to Avoid the Mistake:

Develop loan procedures, including:

- A system for determining the participant's maximum loan amount during the loan approval process. The participant's account balance and prior loan history should be readily available to the individual(s) responsible to ensure 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. For the process to work, the payroll service provider must know to withhold the loan repayments and needs enough information to determine the correct withholding amount. In addition, the payroll system needs to be able to 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.
- Accurate software (or other tools) used to determine loan limits and repayment amounts.

9b) The plan made loans to individuals who are disqualified persons and the loans are prohibited transactions under Code section 4975.

Prohibited transactions under Code section 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 the loan meets specific requirements.

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

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 according to specific provisions stated in the plan,

- bear a reasonable rate of interest, and
- be adequately secured.

How to Find the Mistake:

To determine if participant loans are prohibited transactions, review the loan agreements and 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.)
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 the loan was:
   a. 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. 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 Code section 4975 apply until the loan is fully repaid. The disqualified person pays the excise taxes on Form 5330, *Return of Excise Taxes Related to Employee Benefit Plans*.

Correction Program(s) Available:

The IRS does not have a correction program that provides relief from the excise taxes owed under Code section 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 consistent with the plan's terms that ensures that the terms of any loan issued to a disqualified person satisfies the conditions for it not to be a prohibited transaction.
- The plan administrator should monitor payments made by the disqualified person to ensure that he or she makes the payments according to the loan's terms.

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

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

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Potential Mistake	Find the Mistake	Fix the Mistake	Avoid the Mistake
10) Hardship distributions were not made properly (More)	Review all in-service distributions and determine that hardship distributions met the plan requirements.	Amend plan retroactively to allow for hardship distributions. If impermissible hardship distribution, have participant return hardship distribution amount plus earnings.	Be familiar with your plan document's hardship provisions. 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.

10) Hardship distributions were not 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 both because 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 because of an immediate and heavy financial need of the employee if the distribution is for:

- Medical care expenses previously incurred by the employee, the employee's spouse, or any dependents of the employee or if necessary for these persons to obtain medical care;
- Costs directly related to the purchase of a principal residence for the employee (excluding mortgage payments);
- Payment of tuition, related educational fees, and room and board expenses, for the next 12 months of post-secondary education for the employee, 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 these conditions for determining whether a distribution is necessary to satisfy an employee's immediate and heavy financial need. These rules are designed to relieve the employer (and the employee) from looking at resources outside of the 401(k) plan.

A hardship distribution described in the 1st, 3rd and 5th bullets, above, can be made to a participant based upon a grandchild's or domestic partner's need if that individual has been designated as a plan beneficiary. 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 employee's financial need, or
- if the financial need may be satisfied from other resources reasonably available to the employee.

You generally make this determination based on all relevant facts and circumstances. The law deems the employee's resources to include those assets of the employee's spouse and minor children that are reasonably available to the employee. Thus, for example, a vacation home owned by the employee and the employee's spouse, 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 liquidating the employee's assets;
- by ceasing 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.

How to Find the Mistake:

Review your plan document to determine if it allows 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 hardship distribution, 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.

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 the 401(k) rules.
  - Correction may involve a repayment to the plan of the amounts that did not meet the plan's hardship requirements or section 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 2009 and 2010 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.

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Correction Program(s) Available:

Self-Correction Program:
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, 2009, 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.

Voluntary Correction Program:
Employer L may also correct the mistake under VCP by adopting a retroactive plan amendment, effective January 1, 2010, 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 Closing Agreement Program:
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 only made a hardship distribution to an HCE.

Correction Program(s) Available:

Self-Correction Program:
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 according to the principles in section 6 of Rev. Proc. 2008-50 will be permitted.

Voluntary Correction Program:
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 according to 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 Closing Agreement Program:
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 2010 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:

Self-Correction Program:
This mistake may not be eligible to correct under SCP since adequate practices and procedures with regard to hardship distributions were not in place.

Voluntary Correction Program:
Employer M may correct this mistake under VCP. M must request that the five participants who received distributions not meeting the 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 pose a problem because the participants may have already spent the funds. A plan document requiring spousal consent for distributions, plus possible tax issues on the distributions could further complicate the final correction. Correction will depend on 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 IRS agent to determine the proper correction.

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

Audit Closing Agreement Program:
Most plans are eligible for Audit CAP, which allows the plan sponsor to correct the mistake and pay a negotiated sanction. This sanction will bear a reasonable relationship to the nature,

extent, and severity of the mistake, considering many factors, including the extent to which correction occurred before audit. Sanctions under Audit CAP are a negotiated percentage of the Maximum Payment Amount.

How to Avoid the Mistake:

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 errors. 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 the procedures are sufficient to avoid mistakes.
- Only allow hardship distributions that meet the plan document and Code section 401(k) requirements.
- Look for signs that the hardship distribution program is being abused or badly managed.
    - Too many hardship requests by one group or division may be a sign of abuse.
    - Requests for hardship distributions from multiple employees appear identical. Each situation should have its own individual circumstances.
    - Only the highly compensated employees have hardship distributions. This may be a sign that rank-and-file employees have not been properly notified of the availability of hardship distributions.

Return to Table

Potential Mistake	Find the Mistake	Fix the Mistake	Avoid the Mistake
11) The plan was top-heavy and the required minimum contributions were not made to the plan. (More)	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.	Properly contribute and allocate the required top-heavy minimum, adjusted for earnings, to the affected non-key employees.	Perform a top-heavy test each year.

11) The plan was top-heavy and the required minimum contributions were not made to the plan.

The top-heavy rules 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 $165,000 (2012);
- 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, 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.

How to Find the Mistake:

Review the top-heavy rules and definitions found in your plan document. Make the determination regarding whether your plan is top-heavy for each plan year. Be careful to identify the owners and their family members that you employ 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 covering only 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.

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, 2008. According to the plan document's terms, both new employees became eligible for the 401(k) plan on January 1, 2010. Both new employees made elective deferrals to the plan and it passed the ADP test for both 2010 and 2011. During a review of the plan, Employer J determined the plan was top-heavy for the 2010 and 2011 plan years; however, J did not make minimum top-heavy contributions.

Correction Program(s) Available:

Self-Correction Program:
The example illustrates an operational problem, because the employer failed to follow the plan's top-heavy provisions. 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 2010 plan year by the end of 2012. J needs to make the corrective contribution for the mistake that occurred in 2011 by December 31, 2013.
- 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 depends on all the facts and circumstances.

Voluntary Correction Program:
Under VCP, correction is the same as described under SCP. Employer J makes a VCP submission according to 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 Closing Agreement Program:
Under Audit CAP, correction is the same as described 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.

How to Avoid the Mistake:

You should perform a top-heavy test annually. Also, 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.

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Potential Mistake	Find the Mistake	Fix the Mistake	Avoid the Mistake
12) You have not filed a Form 5500-series return and you have not distributed a Summary Annual Report to all plan participants this year. (More)	Find your signed copy of the return and determine if you filed it timely.	File all delinquent returns.	Understand your filing requirement and know who filed and when. Don't assume someone is taking care of it for you. See 401(k) Resource Guide - Plan Sponsors - Filing Requirements

12) You have not filed a Form 5500-series return and have you have not distributed a Summary Annual Report to all plan participants this year

ERISA requires employers and plan administrators to submit reports to government agencies and furnish certain plan information to participants. Plan Sponsors are generally required to file annually a Form 5500, *Annual Return/Report of Employee Benefit Plan,* 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, in addition to the EFAST electronic filing requirements, please visit 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 – 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 – Apprises participants and beneficiaries of plan changes 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 – Outlines in narrative form the financial information in the plan's annual report, Form 5500. You must furnish this to participants annually.
- 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 because of a corporate merger or acquisition.

How to Find the Mistake:

Many employers identify this mistake when they receive a letter from IRS or DOL stating 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 to 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.

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 2010 year.

Corrective Action:
Failing to properly file a Form 5500 return is not correctable under EPCRS. If the IRS contacts you regarding a delinquent Form 5500-series return, you may file it in response to the letter. Include an explanation regarding 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 regarding why the return wasn't filed and request a waiver of the penalty from the IRS.

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, including the CPA, 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.