Scenario #1:

My real scenario involves a common situation of a 401(k) plan that erroneously excluded some part-time workers. The newest VCP procedure was helpful in dropping the makeup contribution required to 50% of the average deferral percentage of NHCEs. However, there is still no de minimus rule for this situation. The client will end up needing to make a contribution of $10 or less for several former employees who can't now be found. I would like to ask, or complain, about why there is no de minimus rule that applies in this case?

If a contribution is being made on behalf of a previously excluded employee, who has since terminated without ever having an account balance, you may be able to justify not making the contribution.

I am assuming that this is a situation where the contribution would have, under the plan's terms, been immediately distributable to the employee. In that case the contribution would be linked to a distribution that would not be made and the corrective contribution would not benefit the affected employee.

Scenario #2:

Operationally, employer excluded temporary employees from participation in 401(k) plan, but prototype plan did not have a provision permitting the exclusion. In determining necessary correction, sponsor discovered there were temporary employees who became permanent and did not elect to participate. Are you still required to make a contribution on their behalf equal to 50% of average deferral rate for the group plus 100% of match, adjusted for earnings? What about the permanent employee, who is terminated and becomes a temporary/on call employee and had never elected to participate when he was eligible?

(1)Yes. Corrective contributions would be required equal to 50% of average deferral rate for the group (highly or non-highly compensated) plus 100% of match (based on the assumption that the excluded employee deferred at an amount equal to the applicable average deferral rate).
(2) The principle is the same. If an employee is erroneously excluded, then we will not guess as to what the employee's decision (to defer) might have been during the period of exclusion. Prior decisions not to defer could have been changed. Consequently, instead of trying to ascertain what the employee might have elected during the period of exclusion, the revenue procedure simply uses the average deferral rate for those employees (highly or non-highly compensated) as a proxy for determining what is her or her deferral might have been.

Scenario #3:

XYZ Company, Inc. is discussing labor relations with their employment law attorney. They note that they have not had nearly as much trouble since they started hiring significant numbers of employees through a staffing agency. They note that the staffing agency personnel are very good and quite loyal, some of them having worked at XYZ for 10 years. Employment law attorney checks with a benefits attorney, who asks for a bit more information. It turns out that XYZ had no idea that the "temporary employees" it used would be "leased employees." Besides, its 401(k) plan document expressly excludes "leased employees." All of its HCEs participate in its plan. All of its regular workforce of 130 also participate. Its 70 "temporary employees" (counting only those who have 12 months of full-time service) do not participate.

The work records of the temporary employees were held by the staffing agency. Unfortunately, up until 5 years ago, XYZ used a large number of staffing agencies, most of which are no longer in business. It has reliable records only for the past 2 years.

Here are the issues.

1. Will this be an audit CAP matter?
2. Would the correction be a plan amendment to add retroactively sufficient "leased employees" to satisfy 410(b)?
3. Would employer then make nonelective contributions at the average NHCE contribution rate and compute earnings at the plan rate?
4. Assume that, based on the last two years, we determine that adding 4 leased employees will satisfy 410(b). Can we select among the current leased employees?
5. How can the employer deal with the lack of information? Will the service allow us to use a reasonable estimate based on the data we have available?

Before answering the question, I should caveat this by saying that the question is answered on the assumption that the "temporary employees" are an excludable class of employees that do not cause the plan to violate the service requirements for eligibility under section 410(a) of the Internal Revenue Code. The IRS Determination Letter program issued a Quality Assurance Bulletin on this issue on Feb. 14, 2006. The web link for this bulletin is:

http://www.irs.gov/pub/irs-tege/qab_021406.pdf

To the questions on hand:

1. **If the plan violates section 410(b), the plan's qualified status is impacted, and therefore it would be an issue that would be eligible for correction under EPCRS (which includes Audit CAP, if the plan is under examination).**
2. **In this case, the plan's terms provided for the exclusion of the "temporary employee." The only reason for amending the plan is to expand the universe of employees to a number that would enable the plan to satisfy § 410(b). In such a circumstance, the proposal to amend the plan to add enough employees that would enable the plan to satisfy coverage should work.**
3. **For this group of employees, the plan would treat them as if they should have been included in the plan retroactively as of the date that they were needed to enable the plan to pass coverage. Since they were excluded from participation during that period, correction could be determined using the methodology provided for excluding eligible employees under App. A § .05 or App. B § 2.02 of Rev. Proc. 2006-27. For the elective deferral piece (assuming the excluded employees are NHCEs), the nonelective contribution could be determined using the average of the deferrals for those NHCEs who were allowed to make deferrals to the plan.**
4. **I am assuming that the current leased employees were also employed during the years in which the plan failed coverage. In general, absent an abusive situation such as the exclusive use of employees with very short periods of service to help the plan pass coverage, I do not think that there would be restrictions on the criteria that the plan wants to use to determine which employees should be added to the plan. However, if the plan is adding employees in an attempt to pass the average benefits test (as opposed to the ratio percentage test), then the plan would need to make sure that the criteria chosen should satisfy the reasonable classification condition outlined in IT Reg. 1.410(b)-4(a).**
5. **There is the option of using reasonable estimates in situations where precise data is not available. Please see section 6.02(5)(a) of Rev. Proc. 2006-27 re: use of reasonable estimates. It in part provides, "If either, (i) it is possible to make a precise calculation but the probable difference between the approximate and the precise restoration of a participant's benefits is insignificant and the administrative cost of determining precise restoration would significantly exceed the probable difference or (ii) it is not possible to make a precise calculation (for example, where it is impossible to provide plan data), reasonable estimates may be used in calculating appropriate correction."**

Scenario #4:

BCD company hires a new HR director, who forgets to give 401(k) plan enrollment kits to newly eligible employees for six months. No one asks for a kit. Has the employer improperly excluded the employees from participation? Is any corrective action required?

It is the employer's responsibility to ensure that the employee is provided with the opportunity to participate in the plan in a timely manner. Thus, unless alternative methods of giving employees notice were available, to the extent that kits are not provided, you could have a situation where the employees were not given the chance to make elective deferrals when they were eligible to do so. If that is the case you would have a case of improperly excluded employees for whom corrective contributions would be required. See App. A § .05 or App. B § 2.02 of RP 2006-27 for methods to calculate corrective contributions on behalf of employees who were erroneously excluded from a 401(k) plan.

Scenario #5:

Plan sponsor amends plan to provide for safe harbor 401k match with the initial plan year for the safe harbor a short plan year (already completed).

The following answer assumes that the plan being amended is a 401(k) plan:

For a plan's safe harbor provisions to take effect for a plan year the notice should have been provided within a reasonable period before the beginning of the plan year. (see IT Reg. 1.401(k)-3(d)(3)). Since the notice was not timely, it would appear that the plan would not have satisfied the requirements for the ADP safe harbor.

It would appear, therefore, that the plan sponsor would still have to make the match because the plan provisions provide for it. Yet, the elective deferrals would still be subject to ADP testing.

If the plan fails the ADP test then assuming the statutory period for correction under § 401(k)(8) has elapsed, correction could be accomplished under EPCRS. See App. A §.03 or App. B § 2.01 of Rev. Proc. 2006-27.

Scenario #6:

I had a client who was deferring money out of employees' paychecks and submitted it into the vendor under "profit sharing" money type vs. "elective deferral" money type.

If the monies are still in the plan, the correction would involve a shift of participant monies from the profit sharing account to the elective deferral account. It could be a straight forward movement in account balances or there may be other consequences to consider. A couple of those situations are described here. You may have earnings issues to resolve if both buckets were invested differently (e.g. profit sharing monies could be in a pooled account and elective deferrals might be self directed). If a participant's elective deferral bucket earned a better rate of return than the profit sharing bucket, then the employer may need to make additional contributions to make up for the lost earnings on account of the contributions being allocated to the wrong categories. Another situation to consider is whether the plan has different provisions for distributions for profit sharing monies and elective deferrals. The

requirements for distributions from elective deferrals may be more restrictive. In that case, the plan may need to recover distributions that otherwise could not have been made had the amounts been properly classified as elective deferrals.

If a participant terminated and received a distribution of his or her vested account balance, then there is a chance that the participant may have been underpaid. The participant would have been fully vested in elective deferral monies. Employer contributions to the profit sharing plan are typically subject to a vesting schedule. Consequently, the plan could have improperly forfeited amounts that the participant should have been fully vested in. Correction would entail the plan making additional distributions to the affected participant.

Scenario #7:

If a plan excludes an employee, the Rev. Proc. indicates that a qualified nonelective contribution (QNEC) must be made to the plan. By analogy, this would apply to other similar situations where the proper elective deferral and/or match amount(s) was not contributed to the plan. This would appear to be a QNEC within the meaning of Code Sec. 401(m)(4)(C), which, by definition, cannot be made available for hardship withdrawal. Since the goal is to put the employee in the position that they should have been, this result does not seem to be the desired result. Is this the result intended by the IRS? Or is it just the result?

It is the result. The corrective QNEC is an employer contribution that is intended to replace the lost opportunity to a participant for making elective deferrals. It is intended that the employer contribution be characterized as a QNEC because the objective is that the participant should be fully vested in those corrective contributions and that they be subject to similar withdrawal restrictions as elective deferrals. The QNEC meets that goal. However, as the question rightly indicates, the follow up result is that if the contribution is a QNEC, then those monies also have a distribution restriction that does not apply to elective contributions i.e. they are not eligible for hardship distribution (ref: 1.401(k)-1(d)(3)(ii)).

Scenario #8:

An employer is using the self-correction component under EPCRS to restore forfeited amounts (adjusted for earnings) in connection with partial plan terminations that occurred in prior years. During the call, representatives from a large, national, 401(k) plan vendor strongly urged the employer to use the DOL earnings calculator to calculate the earnings.

Does the IRS approve of the use of the DOL calculator to calculate earnings under EPCRS?

The default position is that the plan should calculate the amount of earnings that the improperly forfeited amounts would have earned had they remained in the participant's account balance through the date of corrective distribution.

However, in certain situations reasonable estimates may be appropriate. Please see section 6.02(5)(a) of Rev. Proc. 2006-27 re: use of reasonable estimates. It in part provides, "If either, (i) it is possible to make a precise calculation but the probable difference between the approximate and the precise restoration of a participant's benefits is insignificant and the administrative cost of determining precise restoration would significantly exceed the probable difference or (ii) it is not possible to make a precise calculation (for example, where it is impossible to provide plan data), reasonable estimates may be used in calculating appropriate correction." In that context, the earnings rate provided for by the DOL calculator may be an acceptable estimate.

Scenario #9

Trustee erroneously calculated amounts eligible for statutory diversification (10 years of participation and age 55) under single employer ESOP. Excess amounts have been diversified and participant directed under employer's stand alone 401(k) plan. Error discovered when trustee change is being considered. What is proper correction?

EPCRS does not prescribe a "standardized" correction for this failure. Any correction method devised should take into account the correction principles provided for under § 6 of Rev. Proc. 2006-27.

A possible correction might include the following:

(1) Calculation of what the participant's account balance would have been had the excess amounts not been diversified. If the employer stock experienced a higher rate of return than the diversified monies, then the employer may contribute an amount equal to the additional earnings that the account balance would have earned had the excess amounts had not been diversified;
(2) Reduction of additional amounts subject to diversification in subsequent years by the excess amounts diversified.

Scenario #10

Directed trustee erroneously permits participants to self direct profit sharing contribution that plan document requires be managed and invested by Plan Sponsor/Plan Committee. Upon discovery of error, it is determined that the net investment result achieved by participant direction was better (more profitable) than had the profit sharing contribution been invested pursuant to Plan Sponsor direction. What needs to be done?

It depends on the qualification rule that was violated, as a result of permitting self directed investments and the impact on plan participants.

For example, if the participants afforded the opportunity to self direct investments were highly compensated employees, then the plan could be providing a right that discriminated in favor of highly compensated employees- causing the plan to violate the provisions of IT Reg. 1.401(a)(4)-4 .

A possible correction for this failure might be to pool all of the participants' earnings with the earnings from the trust managed by the plan sponsor/plan committee and re-allocate them among all of the participants based on using a reasonable method (e.g., based on beginning of year account balances). However, if the affected participants were all nonhighly compensated employees, or included a fair representation of nonhighly compensated and highly compensated employees, the participants may be permitted to retain the amounts actually earned.