How to Fix a 401(k) Plan's Foul-Ups, Bleeps & Blunders

By Ary Rosenbaum, Esq.

A 401(k) plan is like high price machinery. It is designed, it has highly intricate parts, and something is bound to go wrong if the slightest thing goes off track. Thankfully, retirement plans have a system of self-correction and programs for the plan to go back on track. So this article is how to fix a 401(k) plan's foul ups, bleeps, and blunders.

Mistakes Happen and the Government is rather forgiving

We're all not perfect and the same goes for plan sponsors and plan providers. 401(k) plans have lots of moving parts, so mistakes happen. I always say that if you want a find a problem with a retirement plan, you can. So the point is that mistakes will happen, it's just making sure that they are minor, that they are discovered and quickly corrected. While both the Internal Revenue Service (IRS) and Department of Labor (DOL) try to enforce the rules that they have enacted, they have implemented voluntary compliance programs to allow plans sponsors a method to correct their errors with minimal penalties. Of course that means if you don't fix a plan error and the government on audit discovers it, the penalties will be more severe.

Missing Plan Amendments

Starting a retirement plan requires a plan document, but the plan document needs to be continuously updated and/or redone. Every so often, the IRS requires the plan document to be amended with a tack on amendment to conform the plan to a new law and/or regulation. Every 5-7 years, the IRS will need you to completely restate your plan into an entirely new plan document. The problem with updating your plan every so often is that there are many times where the amendment or new plan document hasn't been drafted by the responsible party for producing it (your TPA or ERISA attorney typically). The issue is that these amendments have deadlines to be signed and if these deadlines are missed, you have a qualification issue, which means that your plan may be disqualified which means that your previous tax deductions for employer contributions will be disallowed and the plan participants will have to declare their retirement account as current taxable income. You can't backdate plan documents and the only way you can sign these amendments done currently is with IRS approval. You will have to have all the missed amendments drafted and signed. You will also have to submit the plan and the amendments to the IRS through the Voluntary Compliance Program (VCP) of their Employee Plans Compliance Resolution System (EPCRS). There will be a set penalty that will be assessed based on the number of the participants and the cost for overall correction will be thousands of dollars, but it's far less costly than having this error discovered on audit.

Not Operating the Plan According to its Terms

Every plan has a plan document and you have to operate the plan according to the terms of the plan document. So if your plan document states employees can become participants after completing a year of service, you can't let them become participants after only six months of employment. So what happens when you discover that your plan says one thing and you have (with the help of your providers)? Depending on the error, you can self correct the error without having to submit to the IRS through the EPCRS. However, if the error is of s substantial nature and the error was spread across a few plan years, then it should be submitted to the EPCRS where you will have to pay a set penalty based on the number of participants.

Late Deposit of Salary Deferrals

When it comes to depositing salary deferrals into a 401(k) plan, plan sponsors relied on the regulations that stated that there would be no issue if the plan sponsor segregated the deferrals from payroll and deposited in the plan before the 15th day of the following month. The problem is that a few years ago, the DOL reinterpreted the rule to mean that the 15th day of the last month is really a maximum deadline and the real deadline should be the day that the employer could reasonably segregate the deferrals from payroll. In addition, the DOL has 7-business day safe harbor rue for plans with fewer than 100 participants. There are too many plans out there that have late deposits of deferrals and this should be corrected as soon as possible because late deposits have to be noted on Form 5500, so the government will know if the TPA properly reports it. The late deposit problem can be self corrected by giving participants an addition to those late deferrals that equal the greater of the plan's actual rate of return or the IRS set underpayment rate. If the amount of late deferrals is considerable, violated the terms of the plan document, or were corrected years after the late deposit took place, it may be wise to forego self correction and file with the DOL's Voluntary Fiduciary Compliance Program (VFCP), allows you to report your late deposits to the DOL. In exchange for applying under VFCP to correct the late deposits, the DOL will issue a "no action" letter that states they will not audit you, just for this error. Under the VFCP program, you are able to use the set IRS interest rate for underpayment (usually 4-6%), rather than the Plan's rate of return. In addition you will pay a nominal excise tax unless you give notice to the participants. It's costlier you to file under the VFCP, but you may get some peace of mind that the DOL "blessed" your correction.

Not letting participants have the opportunity to defer

Surprisingly, there are quite a few instances when employees have met the eligibility requirements of the Plan and are mistakenly not made participants. When it comes to employer contributions, that error can easily be corrected by giving the "missed" participant the contributions that they were entitled to. When it comes to salary deferrals under a 401(k) plan, it's treated differently because deferrals are contributions made by the employee and they can't go back in time to defer money that they have already earned and pocketed in their paycheck. The way to correct this error is a way to make sure that this doesn't happen again. As a plan sponsor, you must make a fully vested, qualified non-elective contribution (QNEC) to the plan for the employee that compensates for the missed deferral opportunity. The amount of the QNEC is equal to 50% of the employee's missed deferral. The missed deferral is not determined by their actual pay, but determined by multiplying the actual deferral percentage (ADP) for the employee's group (either highly compensated employee or non-highly compensated employee) in the plan for the year of exclusion multiplied by the employee's compensation for that year. This error can be corrected through self-correction or through the VCP Program (advisable if it involves more than one year and/or more than one employee).

Participant loans not adhering to the plan or the law

Participant loans can be a nice feature to a 401(k) plan, but they do bring some headaches if the loan program is not handled correctly. A loan to a participant must meet a number of rules under Code §72(p) to prevent the law from treating it as a taxable distribution to the participant. The plan must base the loan on a legally enforceable agreement. The amount of the loan cannot exceed the lesser of 50% of the participant's vested account balance or $50,000 (except for $10,000 de minimis exception if the plan allows it). The terms of the loan should require the participant to make level amortized repayments at least quarterly. The participant must fully repay the loan within five years from the date of the loan, unless the participant uses the loan amount to purchase his or her main home. The way to correct the error depends on what part of the loan rules did the loan violate. If the plan document didn't allow loans, then the participant would be treated as having a deemed distribution, which means there would be taxable income for that loan. If the loan exceeded the loan limits (50% or $50,000), then the participant would have to pay back that excess by coming up with the money or re-amortizing the loan. If the loan exceeded the maximum loan period (5 years for non-home purchase loans), then the outstanding amount of the loan is re-amortized over the maximum remaining period allowed (5 years) from the original date of the loan. Since loans are an exception to the prohibited transaction rules, you must make an application to the IRS VCP program.

These are just a few of the foul-ups, bleeps, and blunders of a 401(k) plan; others will probably be covered in another article. If you or your plan providers find an error, it is recommended that you seek ERISA counsel to find the right method of correction.

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