Retirement Plan Correction Solution
401(a)(17) Failure? It's All Right… 'Cuz You're Saved By the EPCRS

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Zack and Kelly own Bayside, Inc. – an up-and-coming entertainment company and Plan Sponsor of the Bayside, Inc. Profit Sharing 401(k) Plan ("the Plan"). Kelly engaged The Max TPA Firm ("The Max") to administer the Plan for the past year. After garnering much success, the owners decided to hire Jessie, A.C., and Screech – three highly sought-after content producers. All of the employees of Bayside, Inc. participate in and make salary deferrals into the Plan. It turns out that Jeff, owner of The Max, was more interested in flirting with Kelly than properly administering the Plan. Zack decided it was best to get another TPA ASAP, so he engaged Lisa Turtle of Turtle Retirement Services, Inc. During the onboarding process, Lisa noticed that, during the previous Plan Year (2020), Jeff failed to limit compensation to the Internal Revenue Code ("Code") Section 401(a)(17) maximum when calculating employer nonelective contributions to the plan participants, and instead used their actual compensation. (Real SBTB fans are not surprised that Jeff is the culprit in this hypothetical.) As a result, Kelly, Zack, and Jessie (all highly compensated employees) received Excess Allocations in their accounts. Lisa brought this, among Jeff's other careless errors, to the owners' attention. Before they could start to panic, Lisa assured them that everything could be fixed and explained their correction options.

What is the 401(a)(17) Compensation Limit and When Should It Be Applied?

A retirement plan must satisfy the requirements of Code Section 401(a) to be qualified – that is, to be eligible for all the favorable tax benefits offered to retirement plans. Among the numerous qualification requirements is the requirement that the annual compensation of each employee taken into account under the plan for any year cannot exceed $200,000, adjusted by the cost-of-living increases (in multiples of $5,000) pursuant to Section 401(a)(17)(B). This is commonly called the "401(a)(17) Limit." A history of the cost-of-living adjustments for the 401(a)(17) Limit, among others, can be found **here**. This statutory limit must be applied when calculating contribution and forfeiture allocations and any deduction limits under Code Section 404.

Correcting a Section 401(a)(17) Failure Under the Employee Plans Compliance Resolution System ("EPCRS"): To Give or To Take?

Remember, Jeff's error happened during the 2020 Plan Year, and is being corrected in 2021. Therefore, it may be self-corrected under the EPCRS Self-Correction Program ("SCP"), as self-correction is permitted if it occurs by the end of the second plan year following the year of the failure.

There are two methods to correct a Section 401(a)(17) Limit failure: 1) Reduce the account balance of each affected participant pursuant to EPCRS (Rev. Proc. 2019-19) Section 6.06(2); or 2) determine the allocation rate based on the 401(a)(17)-limited compensation of the affected participants, and then increase the amount allocated to the participants whose compensation was not limited by Section 401(a)(17) so that the allocation rates are the same for all participants, based on the correct compensations, amending the plan document to the extent necessary to authorize the additional allocations, pursuant to EPCRS App. B Section 2.07(1)(a).

If Zack and Kelly choose the reduction of account balance method, the account balance of each employee who earned in excess of the 401(a)(17) Limit will be – you guessed it – reduced by the excess amounts, adjusted for earnings. Because the excess amounts would not have been allocated to other employees absent the failure, the excess funds must be put into an unallocated account (i.e, a forfeiture account) that can be used to reduce employer contributions in the current or succeeding Plan year.

Here's what happened and how this correction method is put into practice:

The Plan's definition of compensation includes bonuses. Jessie's base salary in addition to earned bonuses was $300,000 during the 2020 Plan year. However, the 401(a)(17) Limit for 2020 was $285,000. The Plan has a pro rata allocation formula of 5% of the participant's eligible compensation. Jeff did not consider the 401(a)(17) Limit when he allocated the nonelective contributions. So, instead of using 5% of $285,000 ($14,250) for Jessie, Jeff calculated 5% of $300,000 ($15,000). Let's also assume for the sake of this discussion that Jessie was the only employee for whom the Section 401(a)(17) error was made. Under the reduction of account balance method, the extra $750 must be taken out of Jessie's nonelective contribution bucket in her account, adjusted for earnings. The earnings can be calculated using the actual rate of return based on the investments chosen in Jessie's account.

In the alternative, the Plan Sponsor could self-correct the failure by contributing additional amounts to the employees not affected by the failure equal to the percentage of correct compensation provided to the employee who was affected by the failure, and adopt a retroactive amendment that reflects the new operation. Here's how it works:

Instead of taking out the $750 adjusted for earnings, the Plan Sponsor leaves it in Jessie's account to vest. Free money for Jessie! (She's so excited!) But to keep things fair for Screech and A.C. (and any other employees), the Plan Sponsor will contribute money to their accounts based on the percentage of compensation that Jessie received due to the failure. Jessie got a $15,000 nonelective contribution. We divide the $15,000 contribution by the $285,000 statutory limit. (The method of correction cannot violate the statute). $15,000/$285,000 is 5.26%. The plan can be amended for the 2020 plan year for all participants to receive nonelective contributions equal to 5.26% of their compensation, adjusted for earnings. Free money for everyone! (If the plan is a profit sharing plan and the allocation is simply pro-rata, no amendment is required to effect the change; the plan terms are already being followed.)

As a general rule, adopting a plan amendment to cure an operational failure under SCP is not allowed. However, EPCRS allows for three types of retroactive amendments that may be adopted to cure certain operational failures through SCP – one of which is correcting a compensation dollar limit failure under Code Section 401(a)(17).

Obviously, the reduction of account balance correction method is more favorable to the employer because it saves money. On the other hand, allocating money to the unaffected participants keeps all the employees happy. Lisa should present both options to Zack and Kelly and help them decide which correction method is the most feasible.

Other Section 401(a)(17) Failure Scenarios

What if the failure lasted for multiple years and, by the time Lisa discovers the failure, Jessie quit her job at Bayside, Inc. to become a showgirl? Does Jessie just pocket the extra allocation included in her distribution? No. A failure still occurred, regardless of Jessie's current employment status. Instead of there being an Excess Allocation, however, the plan made an Overpayment, as defined in EPCRS, when the excess amount was given to Jessie. Pursuant to EPCRS Section 6.06(4)(a), the Plan Sponsor must take reasonable steps to have the Overpayment repaid to the Plan, adjusted for earnings. To satisfy this requirement, Bayside, Inc., would have to send a letter to Jessie requesting she return the Overpayment, adjusted for earnings accrued from the date the funds were allocated to her account to the date of distribution. In accordance with EPCRS Section 6.06(4)(e), the letter must also notify Jessie that the Overpayment amount is not eligible for favorable tax treatment accorded to distributions from an eligible retirement plan under Section 402(c)(8)(B) (i.e., rollover). Therefore, the Overpayment should be removed from any Individual Retirement Account ("IRA") that received it, and there may be excise taxes on this amount for the years in which it was held in the IRA. Should Jessie decide not to return the Overpayment, Bayside, Inc. must contribute the overpaid amount, adjusted for earnings, to the Plan's unallocated account. Furthermore, if the error continued beyond the 2-year self-correction period, a Voluntary Correction Program ("VCP") filing may be needed to have a complete correction.

What if the Plan had a matching contribution feature? Was Jeff supposed to use the statutory limit when calculating the matching contributions? Yes. Let's say the Plan Sponsor matched 50% of employee deferrals up to 6% of compensation. How much of a matching contribution would Jessie receive if she deferred 10% of her compensation into the Plan? Jessie's compensation is $300,000; however, the matching contribution formula must use the statutory limit ($285,000). The plan would have contributed a match equal to 50% of 6% of Jessie's unlimited compensation of $300,000 ($9,000). Using the appropriate limited compensation amount, Bayside should have contributed a match equal to match 50% of 6% of the statutory limit ($285,000), which comes to $8,550. The excess match is $450.

Need more scenarios? The IRS website has helpful snapshots that explain how to adjust the 401(a)(17) Limit during a short plan year, when participants join or leave the plan mid-year, and calculating the limit for new participants, found **here.**

To Sum It All UP

Of the many qualification requirements, Section 401(a)(17) is one of the easiest to fix via both SCP and VCP. Stay up to date with the cost-of-living adjustments (Ferenczy Benefits Law Center sends out a FlashPoint each year when the new limits are announced, and they can be found on our website in the FlashPoint archives), and always double-check that they are being used when calculating benefits. If the excess money has already been distributed to the participant, they usually won't return it, no matter how great an employer you are.

And, if you have any questions about an excess compensation issue or any other plan problems, be sure to let us know. After all, ***we are your ERISA Solution***!

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