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Retirement Plan Correction Solution
Meltdown in Springfield!
Correcting Automatic Enrollment Failures

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Huzzah! The IRS released Revenue Procedure 2021-30 ("EPCRS"), which extends the sunset of the 0% automatic enrollment correction method outlined in this article from December 31, 2020, to December 31, 2023. [EPCRS, Appendix A, Section .05(9)]. For more information on the EPCRS update, see our ***Flashpoint*** dated July 20, 2021.

It's a sunny day in Springfield. Lisa Simpson is the human resources manager in charge of administering the Doh 401(k) Retirement Plan ("Plan") for the Springfield Nuclear Powerplant ("Springfield Nuclear"). Mr. Burns, the Plan Sponsor and owner of Springfield Nuclear, receives a corrective deferral refund for the third year in a row. Mr. Burns contacts Flanders, the third-party administrator, to find out how to save the maximum amount each year. Flanders suggests adding a Qualified Automatic Contribution Arrangement ("QACA") – a safe harbor 401(k) plan (to ensure that there are no refunds to Mr. Burns in the future) with automatic enrollment (to make sure that all the Springfield Nuclear employees are saving for retirement) with a per-pay-period match. Mr. Burns amends the Plan effective January 1, 2021, to add the QACA match. Neither Flanders nor Mr. Burns notifies Lisa of the amendment to the Plan or explains how a QACA works. Following Flanders' directions, Lisa timely distributes the QACA Safe Harbor notice to participants (never reading it herself), but never implements the QACA's automatic enrollment provision with payroll.

On June 1, 2021, an inquisitive employee, Maggie, asks Lisa why no deferrals were taken from her paycheck, despite what the notice said. After reading the notice for the first time, Lisa calls Flanders in a panic. There's a meltdown in Springfield! What can Lisa do to save the Plan?

Self-Correction is Available!

Lisa and Flanders determine that Springfield Nuclear failed to automatically enroll participants on January 1, 2021, and failed to make per-pay-period matching contributions. Luckily, EPCRS and its Self-Correction Program ("SCP") gives Lisa the tools she needs to save the Plan (and, not

incidentally, Springfield Nuclear). Under EPCRS, SCP is available if the sponsor has practices and procedures designed to keep the Plan in compliance with the Internal Revenue Code (the "Code") and if the failure is corrected by the last day of the third plan year following the plan year in which the failure first occurred. EPCRS provides special rules and correction methods for plans with an automatic enrollment feature to account for the additional complexity of administering these plans.

Failure to Timely Implement Deferral Elections and/or Automatic Enrollment

Automatic enrollment ("AE") failures are treated differently (and more favorably) than traditional elective deferral failures under EPCRS. The failure to implement a participant's deferral election occurs for AE plans when the plan fails to: 1) timely enroll participants; 2) correctly implement an auto-escalation provision; or 3) implement a participant's affirmative deferral election. [EPCRS, Appendix A, Section .05(8)-(10)].

The "Normal" Failure to Implement Correction

Typically, a company must correct a failure to timely implement a deferral election by making a qualified nonelective contribution ("QNEC") in relation to an affected participant's missed deferral. The QNEC must equal the participant's "Missed Deferral Opportunity" ("MDO"), which is defined as 50% of the amount the participant elected to defer. However, if certain criteria are met, the QNEC may be reduced to 25% of the MDO. But, for plans with AE provisions, there is a special deal: the employer may avoid making a QNEC at all if certain conditions are met. For more information about the traditional and 25% MDO correction methods, see our ***Solution*** dated October 1, 2018.

Automatic Enrollment 0% MDO Safe Harbor

Under EPCRS, plans with AE provisions are not required to contribute a QNEC if the following three conditions are met:

1. **The correct deferrals start** on or before the earlier of:
    - 9½ months after the end of plan year in which the failure occurred; or
    - The pay period on or after the end of the month following the month during which the affected participant notifies the Plan Sponsor of the deferral failure. [EPCRS, App. A, Section .05(8)]

    In our case, Maggie notified Lisa of the failure on June 1, 2021, and employees are paid semi-monthly, on the 1st and 15th of the month. Therefore, to meet this first condition, correct elective deferrals must start for all affected plan participants by August 1, 2021 (i.e., the first paycheck in August, the first pay period after July 31st, the end of the month following the month during which Maggie notified Lisa of the failure).

2. **The employer must make a corrective matching contribution** if the affected employees should have received a required or discretionary matching contribution for the period of failure. Please see the below "Matching Correction" section for additional guidance.

3. **Notice must be provided** to the affected participants within 45 days of correct deferrals starting. The notice must include the following:

- General information relating to the failure, such as the percentage of eligible compensation that should have been deferred and the approximate date that the deferral should have begun. You do not need to include a statement of the dollar amounts that should have been deferred.
- A statement that appropriate amounts have begun to be deducted from compensation and contributed to the plan (or that appropriate deductions and contributions will begin shortly).
- If applicable, a statement that corrective allocations relating to missed matching contributions have been (or soon will be) made. Information relating to the date and the amount of corrective allocations need not be provided.
- An explanation that the affected participant may increase his or her deferral percentage to make up for the missed deferral opportunity, subject to the annual legal limits on deferrals under Code §402(g).
- The name of the plan and plan contact information (name, street address, email address, and telephone number).

If Lisa gets the payroll department to start withholding correct deferrals on the July 15, 2021, paychecks, the affected participants must receive the notice by August 29, 2021.

If these requirements are not met, the Plan must correct the failure using the traditional QNEC equal to the 25% of MDO method (if it can meet the requirements for this method) or the 50% of the MDO method. In addition, the traditional QNEC method must be used for affected participants who terminated employment before the correction is made (because they cannot make up for the missed deferrals by increasing a current deferral election.)

Making the Correction for the Missed Matching Contribution

Flanders will calculate the corrective matching contribution on Lisa's behalf using the following steps:

<u>Step One: Calculate Missed Deferrals</u>

First, a plan must determine each affected participant's missed deferral amount. AE and auto-escalation are treated under EPCRS as if they were affirmative elections at the default percentage. [Treas. Reg. §1.401(k)-1(a)(3)(ii)]. Therefore, the missed deferrals for the failure to implement AE or auto-escalation is equal to compensation for the failure period, multiplied by the applicable AE or auto-escalation percentage elected in the plan document.

If the correction is caught timely, EPCRS makes things easy for us. The missed deferral during the initial period is 3% of the affected participant's compensation in a plan with AE, regardless of the plan provisions… even if the plan's automatic enrollment percentage for the initial year is higher. [EPCRS Appendix A.05(2)(d)(ii)]. The ability to use the default 3% ends at the end of the plan year following the plan year in which the initial failure occurred.

The corrections for QACA failures may be a little different. QACA plans have an "initial period" when the minimum default deferral rate must be at least 3%. This initial period begins on the date default deferrals start for the participant and ends on the last day of the following plan year. [Treas. Reg. §1.401(k)-3(j)(2)(ii)(A)]. After the initial period, the deferral percentage is automatically escalated at the rate of 1% per year, until the AE percentage hits not less than 6% of compensation. If the plan provides for an initial AE rate of 6% or more, this escalation part of the correction can be eliminated.

Lisa's review of the Plan amendment reveals that its provision automatically enrolls participants at 4% of compensation for the initial period, with a 1% auto escalation each year thereafter (up to a maximum of 15%).

Because the Plan only added automatic enrollment January 1, 2021, all participants without affirmative elections would have been automatically enrolled at the 4% of compensation rate and are still in their initial period. Nonetheless, the missed deferral is 3% of compensation, because of the default provided by EPCRS noted above.

If Lisa failed to discover the failure in 2023, the 3% default deferral rate would not be applicable, and the correction would have to start with the 4% automatic enrollment default and then include all scheduled increases.

Step Two: Calculate the Match

The failed match is equal to the amount that should have been contributed, based on the Missed Deferral, and not the MDO.

The Plan's QACA match formula is 100% on the first 1% of compensation deferred, plus 50% on deferrals between 1% and 6%. Now that Flanders has determined each participant's missed deferrals, calculating the match is a breeze.

As discussed above, the participants who were subject to AE are all presumed to have a missed deferral of 3%. The matching contribution on that 3% is equal to 2% of compensation for each pay period from January 15, 2021, through June 30, 2021 (i.e., 100% of the first 1%, plus 50% of deferrals in excess of 1%, or for the algebraically minded: .01 + .50(.02) = .02).

Don't forget about the employees who made affirmative elections and deferred into the Plan! They should receive matching contributions based on their actual deferral elections for each pay period during that same six months, if Lisa didn't match their contributions.

Step Three: Calculate Earnings

SCP requires plans to contribute an amount to reimburse the participants for the lost investment earnings that would have been added to their account had the missed matching contribution been made. Earnings are calculated using the following guidelines:

- Earnings for a failure to implement automatic enrollment or auto-escalation for participants without investment elections are based on the rate of return of the plan's default investment alternative ("DIA"). [EPCRS Appendix A, Section .05(8)(b)]. If the DIA suffered a loss during the failure period, the plan is not permitted to reduce the total matching contribution—the corrective amount is simply the contribution with no earnings.
- The rate of return for a participant who made an affirmative investment election is the actual rate of return of the participant's chosen investment option(s) for the period of failure. If desired, and the participant is a nonhighly compensated employee, a plan may instead use the highest rate of return experienced by any fund offered by the plan for the period of failure. [EPCRS Appendix B, Section 3.01(3)(b)].

Mr. Burns Needs to Learn

The meltdown in Springfield happened because Mr. Burns failed to communicate with the person who actually administers the Plan, Lisa. This is a great opportunity for Flanders to jump in to help prevent issues in the future. During the annual review of the Plan, Flanders discusses the day-to-day operations with Mr. Burns and Lisa to ensure that Mr. Burns understands the importance of communication and the proper delegation of responsibilities to capable individuals. Mr. Burns selects Lisa as the Plan's primary contact to ensure that she receives copies of all signed amendments going forward. Mr. Burns may have the last word, but he needs Lisa to accomplish his goals.

If you have questions about automatic enrollment, corrections, or anything else, let us know. *Remember, we are your ERISA solution!*

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