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Compensation Exclusions

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Another March 15 has come and gone and you're returning to the office refreshed. You check your email to find this alarming message from your client, Taylor, the director of HR: "Our auditor is telling us we've been using the wrong compensation in our plan. We paid a bonus to several participants in 2014 and didn't take out deferrals. Now we're being told this money should have been included in calculating deferrals and the matching contribution! How do we fix it?"

Your answer should be: "Don't fret! This is a common failure and while it should be taken seriously, it can be corrected and I can help you."

Helping Step 1: Determining the Employer's Corrective Contribution

For purposes of this Solution, we are going to assume that this client has only deferrals and discretionary matching contributions to deal with. The data elements that you will need to help correct the affected participants include:

- Deferral rates or amounts (if flat dollar);
- The matching contribution formula for the applicable period;
- Each affected participant's actual rate of return for the applicable period OR, if actual data is unavailable or too costly to calculate, you can use the investment with the highest rate of return. (To learn more about earnings and how to properly calculate based on the failure involved, see our Solution on Corrective Earnings)

To account for the missed deferral, you will calculate and contribute the aptly-named Missed Deferral Opportunity ("MDO"). Under the current Internal Revenue Service Revenue Procedure 2019-19 (the "EPCRS" procedure), there are several ways to calculate the MDO or possibly avoid it altogether. In this scenario, the client's failure is outside of the two-year self-correction window and must be corrected using the 50% MDO formula. Other Solution articles will address the specific situations where an alternate MDO formula may be applicable.

To begin your correction, you must first calculate the actual missed deferral. Note that, if the affected participant elected to defer a flat dollar amount and the bonus was paid on the same

check as a regular payroll, there may not be any correction required. However, if the bonus is paid off-cycle, then the flat dollar amount should have been withheld from that check and now represents the missed deferral. If the affected participant elected a deferral rate that is equal to a certain percentage of compensation (most common), the missed deferral is the bonus amount multiplied by this percentage.

Because the participant received the entire bonus as income, and is now also receiving a corrective contribution, the MDO is calculated using only 50% of the missed deferral to avoid a windfall to participants. The resulting corrective Qualified Nonelective Contribution ("QNEC") needs to be contributed to the participant's account, including earnings.

Let's look at the records for one participant: Thomas. Thomas received a $1,000 bonus at the end of 2014. During 2014, Thomas deferred 4% of his pay. Had the payroll processed correctly, $40 would have been deferred from Thomas's bonus and contributed to his account in the plan. Therefore, Thomas's MDO is $20 ($1,000 x 4% x 50%). (Keep in mind that this amount could still be reduced, or completely eliminated, to comply with plan limits or deferral limits per Internal Revenue Code §402(g).)

Unlike the MDO, the missed matching contribution is calculated based on the entire missed deferral amount. There is no concern about a windfall because there is no associated income the participant has enjoyed.

In our example, assume that Thomas's plan provided a match in 2014 equal to 100% of deferrals up to 3% of compensation and 50% of deferrals equal to the next 2% of compensation. Thomas contributed 4% of his salary. He is entitled to a match of 100% of 3% plus 50% of 1%, for a total match of 3.5% of compensation. Based on a $1,000 bonus, Thomas's missed matching contribution for his bonus is $35. Thomas is also entitled to lost earnings on the matching contribution. As mentioned above, if Thomas is not entitled to a MDO because of the plan limits or §402(g) limit, he will also not receive a corrective matching contribution.

Helping Step Two: Funding the Correction

You've finished your calculations. What now? The Plan Sponsor must fund the entire correction! Even if some of the matching amount will be immediately forfeited, you still must fund it to make the trust whole.

Suppose Thomas terminated his employment in 2015 and had not vested. What happens to the money? The MDO, as an elective deferral, *and the earnings thereon,* are always 100% vested and will be contributed to his account. The missed matching contribution, and the earnings thereon, are also contributed to the plan. However, because Thomas was not vested and has terminated employment, the matching portion and earnings may be deposited directly to the forfeiture account, rather than to Thomas's account. Always make sure that you print proof of the contribution from the recordkeeping/trust and keep the records with the plan documents.

Helping Step Three: Determining the Earnings

Earnings can be calculated once the corrective contributions are funded. Appendix B of EPCRS provides you with clear instructions on how to calculate earnings.

In this instance, as participants have made an election to defer, likely they have also made an election as to the investment of their accounts. The preferred method for calculating earnings is

to use the individual participant's rate of return for the applicable period through the date of correction. Absent the ability, or desire, to calculate the actual rate of return for each affected participant, if the majority of affected participants are non-highly compensated, you may use the earnings rate for the fund available in the investment line-up with the highest rate of return. If the majority of affected participants are highly compensated, you may use the plan's weighted average rate of return.

Once you fund the earnings, just like you did with the corrective contributions, make sure that you print proof of the deposit and keep the record with your plan documents. You're done!

Helping Step Four: Learning the Lesson

Being able to correct is a relief, but how does your client avoid the issue going forward? Taylor probably won't make the same mistake after the trauma of this experience, but what about her successor? Education initiatives can help! If the people monitoring and administering the plan understand the definition of compensation and why it is important, they will be better able to avoid and detect errors. It's also a good idea to have someone regularly checking payroll – whether it is done in-house or by an outside vendor. Payroll systems often use codes for simplicity and they can default to including or excluding certain types of income from deferrals. If those codes don't align with the plan's definitions for compensation, your payroll is set up for failure. Finally, you can amend the plan document to match what the Plan Sponsor really intended to do on a go-forward basis. This will not correct prior issues, but it can put the Plan Sponsor on the right track for the future.