Earnings: When and How To Calculate

Alison J. Cohen

To err is human, to calculate earnings – less than divine. Many of us love to default to the U.S. Department of Labor's (DOL) Online Calculator. It's simple. It's elegant. And, if we're being honest with ourselves, the end result tends to be much cheaper than the alternatives. But, despite the undeniable gravitational pull toward the Online Calculator, it is important to understand when, and how, it should be used and what the alternative requirements are.

The First Flavor of Earnings

Revenue Procedure 2019-19 ("EPCRS"), Appendix B, is your source of information for many earnings discussions. Section 3 is your friend for situations when additional contributions are required. Even within this one section, there are several options to use depending on the unique circumstances with which you are dealing.

If you happen to have a plan that uses a pooled employer-directed trust, you get to use the actual rate of return (ROR) for the Period of Failure. A Period of Failure begins when the failure occurs and ends when the failure is fully corrected. Full correction means that not only the principal amount gets funded, but also the deposit of the corresponding earnings.

Things start getting interesting when you are dealing with participant-directed plans. And, the majority of plans with which administrators deal with are participant-directed. Your first option is always to go with actual earnings based on the participant-chosen investments. But, in some instances, a correction may affect enough participants that calculation of each individual ROR is totally impractical.

As an alternative to determining actual earnings for a participant's account, and if the affected group is predominantly made up of non-highly compensated employees (NHCEs), you **may** use the earnings rate for the available fund in the investment line up during the Period of Failure with the highest ROR. This is clearly the most conservative – and most expensive – option. You would always be safe if you use the highest ROR. (Note that you determine the investment with the highest ROR for the entire Period of Failure, not separately for each plan year during the Period.)

BUT, let's say that your failure is because the plan accidentally excluded a group of employees. Those affected participants never had a chance to make an investment election, so we have no "actual ROR" to use. Instead of using the highest ROR, you may use the weighted average for the plan as a whole.

In a failure that involves automatic enrollment, does that mean that we have to use the weighted average for the plan as a whole for anyone who was not automatically enrolled? Nope! This is another variation on the flavor of earnings. EPCRS Appendix A.05(8)(b) permits the use of the default investment alternative for calculating the earnings in this circumstance. After all, the default fund would have been where the participant would have been invested had the plan operated correctly. There is a catch to this. (Of course! What fun would it be without a catch?) If the default fund experienced a loss in the Period of Failure, the loss cannot be applied to any corrective contribution, including any corrective contribution related to any matching contribution. In such case, the earnings rate would be 0%.

So, what happens if the failure affects predominantly highly compensated employees (HCEs)? Once again, your actual ROR is your preferred method of calculating earnings. Absent the actual ROR, do HCEs really need to get the highest ROR? No. In this instance, you can use the weighted average or our much beloved Online Calculator. (And there was much rejoicing!)

Other Flavors Can Be Yummy, Too

The above rules relate to earnings when the Plan is making corrective contributions. But, what about instances when a correction will involve a reduction in a participant account balance? A reduction could occur if there is a miscalculation of a matching contribution or profit sharing contribution, requiring the removal of a certain amount from the participant account. EPCRS, Appendix B, Section 2.02(2)(a)(iii)(C) provides the guidance to what we need to do.

If predominantly NHCEs will lose some of their allocations, then we don't have to worry about earnings at all. We can let the NHCEs keep the earnings made on the excess contribution. (And there was even more rejoicing!!) So, in this specific instance, you only remove the excess contribution.

If the plan sponsor is Ebenezer Scrooge, and wants to take the earnings out of the plan, you experience the other side of the contribution coin discussed above. If the predominant group affected is NHCEs, you are permitted to use the fund with the lowest ROR instead of actual earnings. Do you get such a great deal if the predominant group affected is HCEs? Nope. Sorry. You are stuck calculating the actual individual account earnings for HCEs.

What if there is a loss in the participant's account during the Period of Failure? No idea. There is nothing in EPCRS that tells us what to do. However, logic leads us to believe that, if NHCEs are predominantly affected, you could apply the loss and reduce the amount to be recovered. The conservative option for HCEs would be to remove the overage without adjustment for losses.

Of Course, There's Always Chocolate

So, what about the Online Calculator that we love so much? There is a reference in EPCRS that would make use of the Online Calculator possible. Section 6.02(5)(a) discusses reasonable estimates (also referenced in Appendix B, Section 3). You may use the Online Calculator **only if** it is possible to make a precise calculation, but the probable difference between the actual earnings and the Online Calculator is insignificant **and** the administrative cost of the actual calculation would significantly exceed the probable difference.

You can also use the Online Calculator if it is simply not possible to make a precise calculation. When is that the case? For example – let's say there is a 403(b) plan that needs to make a correction. Because each participant has his/her own investment account in which s/he can invest in anything that can be traded, it is impossible to calculate a weighted average or even pick the highest ROR. This may be an opportunity to use the Online Calculator. Another example may be when the correction goes back to a prior plan year for which there are no records available because of a change in service providers or a disaster that destroyed plan sponsor records.

But, Earnings on Late Deferrals Can Be Determined Using Online Calculator, Yes?

Understand that the Online Calculator was designed for use with the DOL's Voluntary Fiduciary Correction Program (VFCP). Only Plans filing the correction of issues through the VFCP are authorized to use the Online Calculator. So, use the Online Calculator at your own risk if you don't want to file under VFCP (or if VFCP is not applicable to your situation)!

Conclusion

The determination of proper earnings may seem like a small issue when correcting a qualification mistake. However, both the IRS and the DOL treat this part of your correction seriously, so you should, too.

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Ilene Ferenczy • ilene@ferenczylaw.com | Alison Cohen • acohen@ferenczylaw.com
Adrienne Moore • amoore@ferenczylaw.com | Adriana Starr • astarr@ferenczylaw.com
Tia Thornton • tthornton@ferenczylaw.com | Leah Dean • ldean@ferenczylaw.com

2635 Century Parkway Suite 200, Atlanta, GA 30345
T 404.320.1100 | F 404.320.1105 | www.ferenczylaw.com