Overpayments…If it Comes Back, it Is Yours

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An Employer decides to sell off its division in San Diego effective January 1st. The Buyer accepts a spin-off of the Employer's 401(k) Plan's assets related to the San Diego employees' benefits into its plan as of the close of the deal. The Employer completes its required annual ADP testing and reports to the Buyer that there are refunds due to certain highly compensated employees ("HCEs"). The Buyer is cooperative, relays this information to the HCEs, and issues the distributions before March 15th like a good pension citizen. On April 1st, the Buyer gets a call from the Employer. There has been a mistake and the ADP testing actually didn't fail as badly as they thought. The refunds were too much. Now the Buyer has to deal with overpayments.

When a Little Is Just Right

The term "Overpayment" is defined in Revenue Procedure 2019-19 ("EPCRS"), Section 5.01(3)(c) as a Qualification Failure due to a payment being made that exceeds the amount payable under the terms of the plan or one that exceeds a statutory limitation (such as the Internal Revenue Code §415 limitation). It can include payments from either a Defined Contribution or a Defined Benefit plan. Section 5.02(4) has a similar definition for 403(b) plans.

EPCRS Section 6.02(5) provides for several exceptions to a full and complete correction. EPCRS Section 6.02(5)(c) allows a plan that has made an Overpayment to a participant in an amount that is less than $100 to let the participant go on his/her merry way. If the Overpayment was part of a rollover to another qualified plan or IRA, the Plan Sponsor doesn't even have to notify the participant or beneficiary that the Overpayment is not eligible for favorable tax treatment (i.e., rollover).

So, in our example, if the differential between the original ADP refund and the corrected ADP refund is less than $100 for a participant, the Buyer doesn't have to contact the HCE and ask for the Overpayment back.

What if the Overpayment Is Over $100?

EPCRS Section 6.06(1) addresses the general principles for handling Excess Amounts and is your starting place for the correction. A distribution of an Excess Amount is not eligible for favorable tax treatment, as noted above. So, if a distribution is rolled over to a qualified plan or an IRA, the recipient must be notified of the Excess Amount, and the Form 1099R must be corrected to reflect the Excess Amount as taxable income if it is not returned to the plan.

EPCRS Section 6.06(4)(a) states that in general, a plan sponsor has to take "reasonable steps" to have the Overpayment returned to the plan, adjusted for interest. As most of us know, the plan sponsor can ask all it wants, but the overpaid participant doesn't usually return the money. And certainly, the participant will not pay the lost interest either—especially if the participant has taken the Overpayment in cash.

The next alternative in ERISA Section 6.06(4)(b) allows the plan sponsor or another person to contribute the difference to the plan, making the plan whole. (This is not necessary if the amount distributed to the participant was considered to be an "Overpayment" because there was no distributable event. In that case, no contribution is required, and the participant's account — reduced by the amount he or she received—is simply left as is.)

So, what does the Buyer in our example do about the ADP failure correction?

- Step One: Determine if any of the corrections are under $100. If so, we can ignore these people.
- Step Two: Prepare a notification to all other affected HCEs, informing them that they have received an Overpayment. As we know that ADP testing failure refunds are ineligible for rollover treatment, these amounts were never eligible for any favorable tax treatment. So, all the plan sponsor can do in the notice is request that the HCEs return the Overpayment, plus earnings.
- Step Three: Because the amount distributed is an Overpayment, and because there was no distributable event, there is no need to unjustly enrich the participants' accounts by having the employer contribute the money back to their accounts. Therefore, the accounts are left as is, decreased by the Overpayment amount.
- Step Four: The correction should always be documented, either in memo format for self-correction or through the Voluntary Correction Program submission.
- Step Five: The plan administrator should carefully consider any necessary changes to its procedures to prevent a recurrence of the problem.

But, what about earnings (assuming anyone wants to actually repay the Overpayment)? How do they get calculated? In accordance with EPCRS Section 6.06(4)(b), earnings are at the plan's earnings rate from the date of the distribution to the date of the correction of the Overpayment.

Defined Benefit Plans—The Other White Meat

If the plan happens to be a defined benefit plan, EPCRS Section 6.06(3) gives a few options for correction. Having the employer contribute the amount of the Overpayment to the plan, instead of seeking recoupment from the plan participant or beneficiary, is one choice. The plan sponsor is also able to adopt a retroactive amendment to conform the plan document to the plan's operation (i.e., to provide an increased benefit to the person who got the Overpayment, so that the amount ceases to be an Overpayment). This, of course, is permitted only if it would be nondiscriminatory, which usually means that the affected participant must be a non-highly compensated employee ("NHCE"). If the failure is because of an IRC §415 excess, the plan sponsor may also reduce future benefit payments.

What if the Overpayment Is Huge?

Sometimes participants are overpaid a significant amount. In that case, the plan administrator is within its rights to attempt to recoup the Overpayment through legal means, particularly if the amount involved is beyond the plan sponsor's ability to correct. In that case, the plan administrator must evaluate whether the cost of this action is worthwhile, and whether any insurance that the plan or the plan sponsor has will cover the correction or the litigation.

Conclusion

Correcting an Overpayment is usually not an overwhelming problem, and the correction is carefully discussed in EPCRS. Be thoughtful in the process of fixing the error, document what you do, and reassess your procedures, and all will be good.

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