The Eligibility Conundrum

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Eligibility failures can happen in many different ways and for many different reasons. That's the fun of human beings – we are a unique and creative lot. Accidental exclusions can occur because of a misunderstanding as to the age and service provision that's actually in the plan document or it could be even broader and an entire class of employees get excluded (how 'bout them part-time and seasonal employees?). There are also the occasional oopsies that seem to affect only a single employee that fell through the cracks or more nefarious 'accidents' involving people the HR Director didn't like. The only real reason to understand why the eligibility failure happened is to make sure that procedures are tightened up to make sure it doesn't happen again.

So, what's the solution? Here we discuss how to fix deferrals and matching contributions.

EPCRS Is the Way

Depending on the type of eligibility failure, when it happened, and when it is discovered, there are multiple ways of correcting the plan. Your guide to fixing eligibility failures is Internal Revenue Service ("IRS") Revenue Procedure 2019-19 (i.e., the EPCRS Procedure), Appendix A. We recommend always having a hard copy of the Rev. Proc. printed out and ready at your fingertips. You can highlight, tab, and notate the language that you refer to most often and you'll quickly become the office 'go-to' person for corrections.

Under most circumstances, EPCRS requires the Plan Sponsor to make a QNEC on behalf of the missed employee equal to a percentage of what the employee would have otherwise deferred. This QNEC amount is sometimes called the "Missed Deferral Opportunity" or MDO.

How Is the Correction Done?

Starting with the easiest eligibility failure – Susie turns in her enrollment forms on time to HR right before Dennis, the HR Director, goes away on vacation. Susie's form sits in Dennis's in-box and is quickly consumed by other work that comes in while he's away. Alas, Susie doesn't get enrolled. What do we do with Susie now?

Well, it depends. (Always a good compliance answer!) If Susie discovers the failure quickly and brings it to the attention of HR while she still has 9 months left in the year to catch up her deferrals – Dennis just enrolls Susie ASAP, notifies her of the ability to increase her deferrals to catch up for the missed time (the required content for the notice is found in EPCRS, Appendix A, Section .05(8)(c)), and tightens up his departmental procedures for when he's on vacation. Why doesn't Susie get a corrective contribution? Because she has what the IRS considers a reasonable period of time to still get her full deferral amount in for the year, so long as she's provided with notice of this opportunity. So, no harm, no foul.

Let's say instead that Susie doesn't check her paystub and doesn't pay attention to her deposits (amazing, but these folks exist!). Now the failure isn't discovered until the following year, when the plan's auditor is there for the annual review. What do we do now? We are still within the two-year self-correction window (i.e., before the end of the second year following the plan year in which the error occurred) – whew – so, we can self-correct AND we can take advantage of the 25% QNEC option available in Appendix A, Section .05(9)(b). Under that option, the employer contributes 25% of what Susie would have deferred had she been properly enrolled, plus lost earnings.

The keys to unlocking this option are 1) it was caught before the end of the self-correction period and 2) Susie is still employed. Why is #2 important? Because, nebulously, in reading the language in the notice that must be given to affected participants to take advantage of this discounted correction, the participants are told of the option to increase deferrals to catch up on their savings. If you're not employed, how can you increase deferrals to a plan sponsored by a company for which you no longer work? Yes, clear as mud. Hopefully, this will be made crystal clear in the next iteration of the Rev. Proc. But, what if Susie has terminated employment by the time the failure is discovered? Well, move to the next paragraph.

Ok, now let's get crazy and imagine someone not noticing they weren't enrolled in the Plan for more than two years. Another option for this scenario is a Plan Sponsor who excluded a class of employees accidentally and the error was discovered in the plan audit. The auditor may realize that the eligibility failures go back over a decade or more. Where do we now stand?

If the error first occurred outside the self-correction period, we must use the traditional correction formula, which requires the Plan Sponsor to contribute a 50% QNEC.

The moral of this story is that it pays for a Plan Sponsor to take a good hard look at the end of every year to make sure all eligible folks have been brought into the plan.

Okay, But What is the QNEC Based On?

Now we have a basic understanding of the different timing standards and QNEC options, how do we figure out what deferral rate we should use in the correction? If Susie has completed an enrollment form, the answer is right there. Use Susie's actual elected amount. Easy. But, what about the more likely scenario, where we have participants who were simply not permitted to enroll, so never made a deferral election?

Typically, the answer from Appendix A.05(2)(b) would be to use the ADP for the group of which the affected participant is a part. So, if Skippy is a non-highly compensated employee ("NHCE") who was never enrolled, we would use the NHCE ADP percentage as Skippy's deferral percentage for correction calculations. However, there are exceptions to this rule. (Where would be the fun in a rule with no exceptions?) If the plan in question uses automatic enrollment, you would use the automatic enrollment percentage elected in the plan document. So, suppose that

Skippy says that, if given the opportunity, he would have deferred 10%, but the automatic enrollment percent is 3%. Skippy is considered to be at 3% for calculation purposes. Sorry, Skippy.

What if the plan is a safe harbor plan? There is no ADP percentage to use, so what happens? If the plan is a safe harbor matching contribution plan, according to Appendix A.05(2)(d)(i), you are required to use the deferral rate that is subject to a matching rate equal to 100% of the deferral. For example, if the plan provides a basic safe harbor match, the match formula is 100% of the first 3% and 50% of the next 2%. In that case, you would use 3% as the participant's deferral percentage for correction. But, for example, let's say the plan sponsor hates math and uses the 100%-up-to-4% enhanced safe harbor match. In that case, the participant's deferral percentage for correction would be 4%. A small price to pay for wanting a simpler safe harbor match formula. For a safe harbor nonelective plan, simply use 3% as the deferral rate.

Easy Peasy Mechanics

Now, we know which deferral percentage to use and which type of QNEC applies. It's time to do the actual calculation. You should be able to set up a standard Excel template with formulas to be used for future client corrections. A typical spreadsheet might have the following columns:

1. Participant Name
2. Compensation
3. Applicable deferral %
4. Missed deferral (Column B x Column C)
5. Matching Contribution (calculated using the full missed deferral amount and NOT the corrective QNEC)
6. Missed Deferral Opportunity/QNEC (Column D x 25% or 50%, as applicable)
7. Earnings on Match (Column E x earnings %)
8. Earnings on QNEC (Column F x earnings %)

Earnings calculations will be covered in a separate Solutions article as the breadth of this topic is too large to adequately cover here.

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